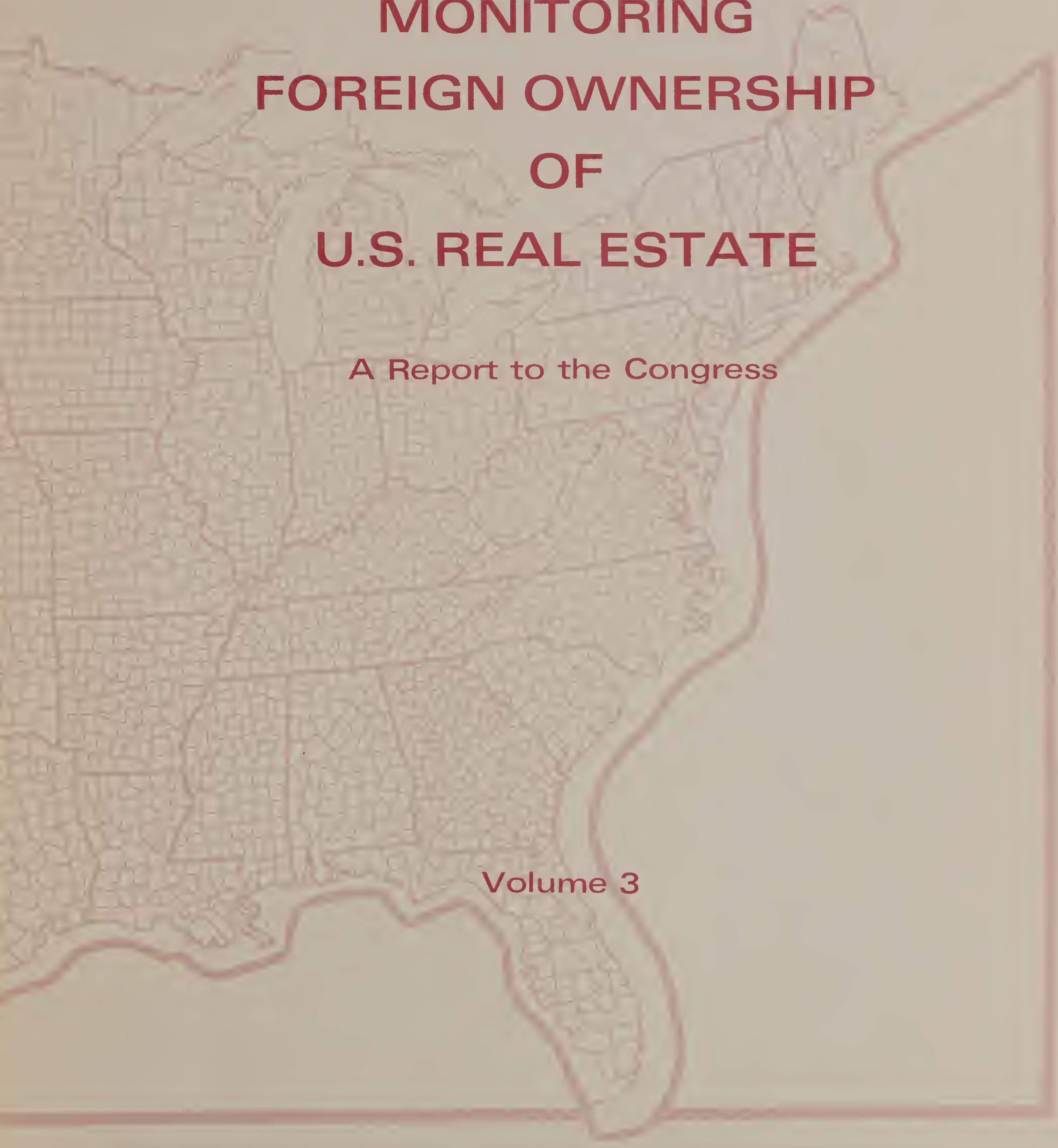
MONITORING FOREIGN OWNERSHIP OF U.S. REAL ESTATE



A Report to the Congress

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Chapter 13

ECONOMIC EFFECTS OF FOREIGN FARMLAND INVESTMENTS ON FARMS AND RURAL COMMUNITIES

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INTRODUCTION: IMPACT ON FARMS

The issues involved in analyzing the economic impacts of foreign investment are complex and made more so by: (1) the difficulty of separating foreign investment impacts from related concerns; (2) the distinction between economic factors and deeply held agrarian values; and (3) the lack of comprehensive data series to serve as the basis for an empirical evaluation.[1/]

The first issue has been dubbed a "confusion of context" by Fletcher and Cook (27)[**/] in a report to the Senate Committee on Agriculture, Nutrition and Forestry. They ask whether the present concerns are attributable to foreign investment in land alone or are questions about the price of farmland, the future of the family farm, and the role of domestic absentee ownership of farmland. For analytical purposes, this indicates the need

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1/ The authors recognize the importance of the political, legal, and sociological implications of foreign investments in farms and farmland, but the questions addressed in this paper focus on the economic impacts of these foreign investments.

**/ Numbers in parentheses refer to items in the references at the end of this chapter.

for a "with and without foreign investment" rather than a "before and after foreign investment" methodology. Specifically, it means that the relevant measures of the impact of foreign investments in land must be separated from the trends in investment in land due to domestic forces.

A related issue is the distinction between economic impacts and real or perceived "threats" to widely held rural values and beliefs. These values may range from the "idealization of farming as the basic occupation of man" [quoted from Soth (64) as definition of agrarianism, p. 663] to the question of whether there is a general attitude of hostility toward "aliens" (66)[2/]. These values and beliefs are important to the American citizenry and need to be considered by policymakers. However, it is important also to recognize that these forces are based on a system of values and needs to be distinguished from the positive or negative economic impacts resulting from the foreign investments in farmland being analyzed in this report.

A third problem adding to the complexity of the issue is the lack of even the most basic data series on the extent of the foreign ownership of U.S. farmland.[3/] The forthcoming Census of Agriculture (74) will include information based on the question of whether "any or all of the acres in this place were owned at anytime in 1978 by individuals who are not citizens of the United States, or by foreign corporations, unincorporated associations or a foreign government" (p. 41). These data, plus the information that can be developed from the data provided by the new registration requirements of foreign investors in land (75), will provide an indication of the magnitude and distribution of foreign investments in the United States. Unfortunately, these data were not available at the time this analysis was conducted.

Breimyer (9) argues that the magnitude of foreign investment purchases "amounts to a nonissue" (p. 38). His rationale is that as long as the concern and interest in foreign investment in farmland continues, informed U.S. policy debate is needed.[4/] In essence, he is arguing the need for analyzing the policy implications of the question even if adequate empirical data are not available.

[2/] Summers (66) argues that any intrusion into affairs of a local community is regarded as a threat to its existence and to the valued things which it represents. He suggests that it does not matter whether the intruder is a foreign absentee landlord or State and Federal officials; they all tend to be regarded with thinly veiled hostility.

[3/] A subsequent section examines the basic data sources available for analyzing the foreign investment question in more detail.

[4/] A poll of State Governors by the General Accounting Office (80) in 1975 reported that only 4 percent of the Governors indicated foreign investments in farmland was a problem at that time, while 20 percent suggested it could be a problem in the future, 36 percent saw no present or future problems on this issue, and 22 percent either failed to respond or indicated lack of information for making a judgment.

The philosophical approach taken in this chapter emphasizes the conceptual basis for evaluating the positive and negative impacts of foreign investments in farmland. The limited data available from a multitude of sometimes highly fragmented sources will then be used to evaluate the conceptual arguments.

The organization approach concentrates on two major issues. The first segment of the paper emphasizes the microeconomic and aggregate microeconomic impacts of foreign investment on the farm sector.[5/] Four topics are discussed: (1) uniqueness of farmland as a resource; (2) conceptual issues related to foreign investments in farmland; (3) analytical measures of the impacts of these investments; and (4) research methodologies and data needs for improving the measurement of the impact of foreign purchases.

The second segment of the paper includes an examination of the economic impacts of foreign investment in farmland on the rural community. This section focuses on the impact of foreign investment on: (1) the intensity of agricultural production; (2) the spatial distribution of agricultural input purchases and output sales; (3) the economic structure of rural communities; and (4) the fiscal operations of local governments.

UNIQUENESS OF FARMLAND RESOURCES

To provide a framework for addressing the question of the impact of foreign investment in U.S. farmland, the more basic question of whether farmland should be viewed differently than any other resource must be analyzed. The reason is that the concerns being expressed about the negative impact of foreign purchases of farmland do not seem to extend to investment in assets other than farmland. Many States, for example, have high-level, publicly supported organizations whose major function is to entice foreign investors to locate industrial plants in their State. Just two examples of success in these endeavors are the Michelin rubber facilities in Georgia and the Volkswagen plant in Pennsylvania. Thus, the question, why are nonfarmland sales being encouraged and hailed as successes, but farmland sales being subjected to criticism? The major arguments seem to fall into three

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[5/] Van Loo's study (chapter 15) in this compendium of papers examines the macroeconomic impacts associated with foreign investment in U.S. real estate. There is a high degree of association between the micro and macroeconomic impacts resulting from foreign investments in farmland. The delineation of the two types of impacts in this study follows the pattern normally used in economic analysis.

categories: (1) the infinite life of the land resources; (2) the fixed physical supply of land; and (3) that land is an immobile resource.[6/]

The "infinite life" argument seems to be based more on emotion than on objective analysis. While it is true that land does not depreciate in the same manner as a specific industrial plant, the more comparable relationship is between "land" and an industrial corporation--both having an infinite life span. The argument that profits from the land can be "drained off" to a foreign country "for the rest of time" also is true for the export of the net returns from investments in any capital asset. Thus, the argument has a good deal of emotional appeal (largely because of strong values attached to farmland) but fails as a criterion for separating farmland purchases from other types of foreign investments.[7/]

The second argument is that we must control the sale of farmland to foreigners because the total supply of land is fixed. More industrial plants can be built, it is argued, but land cannot be reproduced by man.[8/] However, there are difficulties in distinguishing between the "natural attributes" of land and the capital investments affixed to the land. For example, major irrigation projects in the southwestern United States did not increase the physical supply of land, i.e., increase the acreage of land, but most everyone would agree that the effective supply of farmland was increased. The point is that arguments indicating that the supply of land is fixed and therefore that sales to foreign buyers will decrease by a like amount the supply of land available to residents is only true if one employs the rather restrictive natural attributes definition of land.

A related point is that if capital affixed to land increases the effective supply of land, as argued above, then differential rates of foreign and domestic investments in capital improvements to land will modify the effective rate of the sale of land to foreigners. For example, if the foreign purchaser invests in a substantially higher level of direct

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[6/] A related argument, but less essential to the central issue being examined in this paper, is the role of land in economic development. Some scholars suggest that land is the crucial input in the country's potential for economic growth, while others believe land has a relatively minor role in enhancing development. See review article by Jansma (39) for a more comprehensive discussion of the issues associated with this controversy.

[7/] Dovring (19) argues that while in theory any set of assets owned by a foreign investor can be maintained indefinitely, the chances of this happening are greater for farmland because of risk and management considerations.

[8/] Minor additions to the total physical supply of land are possible (the Dutch holders, for example) but the amount is relatively insignificant.

improvements to the land, then measures of the economic supply of land moving to foreign ownership based on acreage will tend to be understated. The converse, is, of course, also true.

Perhaps the most unique characteristic of land is its immobility. Most factors of production can be moved (subject to transportation costs and import and immigration regulations) to take advantage of higher returns in a different location. But land lacks this mobility. Land must be viewed as not only occupying space but rather as occupying a specific space with economic significance.[9/]

The importance of this immobility constraint in analyzing the impact of foreign investments is twofold. First, a desire to invest in U.S. farmland can be satisfied only by purchases in the United States--the asset cannot be moved to the foreigner's home country. Second, the economic interdependence between a particular tract of farmland and its "economic neighbors" requires that an analysis of the impact of foreign investments must be more comprehensive than those occuring on the farm. Thus, a significant part of this paper addresses the important community impacts associated with foreign farmland investments.

In summary, there are specific attributes of land which require that the impacts associated with foreign investments in farmland do indeed need to be evaluated somewhat differently than when other types of inputs are purchased. However, it also is important to distinguish between the attributes of foreign investments in farmland which are based on economic differences and those based on differences in the public's concern for specific agrarian values.

CONCEPTUAL FRAMEWORK

The process of analyzing a public issue requires the development of a scheme for addressing the various questions that have been asked about the problem.[10/] That is, the various issues within the overall problem must

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[9/] The value of these locational attributes can be based on either natural conditions (such as access to a stream) or manmade (highways or access to centers of economic activity).

[10/] Timmons (69) provides a useful overview of the incentives for foreign investments in U.S. farmland. The 12 categories of incentives discussed by Timmons include: (1) hedge against inflation; (2) safety of investment; (3) capital appreciation; (4) competitive with alternative investments; (5) tax advantages; (6) favorable dollar-exchange rates; (7) access to U.S. resources and technology; (8) access to international markets; (9) balance investment portfolio; (10) haven for capital and personal safety; (11) economic and political power in the United States; and (12) intangibles such as psyche income from owning land in the United States.

be highlighted so the focus can be on specifics rather than broad generalities. The framework for discussing the specific issues emphasizes the following four subareas: (1) price of land, size of holdings, and availability of credit; (2) conservation, land improvements, and tenure arrangements; (3) land use, agricultural production, and farm income; and (4) additional considerations.

Prices, Size, and Credit Availability

The argument often is made that foreign investors pay high (some say outrageous) prices for land and therefore prevent "legitimate" U.S. buyers from entering the market. To stress the importance of this undesirable impact, the argument often is cast in terms of preventing the young farmer from entering farming.

It is not difficult to use basic economic logic to reinforce the argument that foreign investors do, indeed, contribute to increases in land prices, i.e., additional entrants into the market for farmland place an upward pressure on land prices. A basic tenet of our economic system is that increases in demand without increases in supply will cause prices to raise. However, to adequately assess the potential level and distribution of the foreign investment impacts on price, it is necessary to examine the various economic forces in operation more closely.

These are several questions which must be asked before one can conclude that foreign investment does in fact have a significant impact on farmland prices. First, what are the dominant forces in the farmland market? In reemphasizing the "with and without" framework, it is necessary to assign relative weights to domestic forces such as the pressure for farm enlargements and compare these with the impact of foreign investments in the regional and national farmland market.

A second question is the relative magnitude of the foreign investment activity. It can be argued that the incremental unit of demand supplied by the foreign investor is greater than the overal average, i.e., the foreign purchaser is the catalyst in driving up the price of farmland.[11/] However, if foreign purchases are a very small component of total demand, it would suggest that foreign investors in the market would have relatively little impact on the price of farmland.

A third question is whether tax advantages permit the foreign investor to outbid his American competitor for a tract of land. That is, does the foreign investor have unfair bargaining power because of tax advantages? The validity of this argument is extremely difficult to check and impossible to generalize on because of differential tax consequences of the

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[11/] A hypothesis for further testing developed in the Iowa study (18) is that "Foreign investors have increased the sales price of real estate in local areas by paying premium prices for land, thereby increasing the expectation of other local sellers." (p. 130)

large number of alternative ownership, management, and leasing arrangements available to the foreign purchaser.[12] It seems, however, that the tax situation may, indeed, place the American buyer at a disadvantage. However, it is difficult to disagree with Gaffney (30), who suggests an approach in which the comparative advantage gained through the tax structure is addressed directly, rather than indirectly through regulation of land sales. Without suggesting it is the appropriate solution, it is interesting to note the system used in Ontario, Canada, where ". . . . registration of alien land-ownership (is combined) with a 20 percent tax on alien land transactions." (27, p. 10). The point is that the foreign buyer of land may have some tax advantages over his U.S. counterpart. However, a system of taxation on the foreign purchaser would seem to be a more efficient approach than overall prohibition of land sales to foreigners.

Another argument is that the high prices paid by foreigners block the young farmer's entry into farming. But what are the assumptions inherent in this argument? First, it assumes that foreign buyers are responsible for the high land prices, when in fact, this is an assumption which may not be true. A second assumption is that the young farmer: (1) must be able to purchase land to start farming; or (2) will be forced to pay such excessive rents to the foreign investor that his entry to the farming profession is blocked. Neither of these assumptions seem to be supported by facts.

A recent study by Cruett, Obrecht, and Herr (17) has shed some light on the first assumption. It should be noted that this study was not designed to analyze the impact of foreign investment on land prices, or indeed on land prices in general; rather it focused on the issue of financing entry into farming in the midwestern United States. A major conclusion of the study was that "entry into farming by cash renting or share renting land substantially improves the potential for success relative to ownership methods . . . ." (p. 24). The point is that foreign landownership _per se_ does not block entry into farming and further that starting farming as an owner-operator may not be the most efficient entry mechanism.

A second assumption that higher rents are charged by foreign owners which, in turn, block entry into farming also need to be examined. An Iowa study (18) reported, admittedly as a hypothesis for further study, that "most foreign investors lease the land to local operators, and the lease arrangements do not vary significantly from those of domestically owned farms" (p. 130).

In general, it seems that using the difficulty in entering farming argument as a negative impact of the sale of land to foreign investors is based more on the expression of an agrarian ideal than on economic analysis.

A final consideration with regard to the argument that foreign investors drive up the price of land and thus have a negative impact on agriculture

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[12] Burge (chapter 17, this volume) discusses the tax implication of foreign investments.

is the need to remember the obvious; for each buyer paying "inflated prices" there is a seller receiving the increased returns from the land. Since the sellers usually are also members of the agricultural establishment, the concept of negative economic impacts is real only when viewed from the perspective of the buyer.

Closely related to the question of land prices is the public concern about an increase in the size and decrease in the number of farms.[13/] In this analysis, we are faced with two questions. First, are farms becoming larger and, if so, why? Second, what is the role of foreign investments in land on the changing size of farms?

The first question is addressed by examining the data on changes in farm size and the substantial number of studies currently available on the economies of size in farming. The high degree of interrelatedness of the price-size arguments is obvious in this regard. If the pressure on land prices is primarily due to the desire for farm enlargement, it is directly related to the economies of size question.

The second question concerning the impact of foreign investment on farm size is related to the magnitude of the foreign investment activity (derived from data on foreign sales) and the types of farms being purchased. Conceptually, it seems realistic that types of farms being purchased by the foreign investor would be the larger tracts of land. Reasons for this behavior include: (1) the normally higher transaction costs for foreign buyers can be "spread" over more acres; (2) the tendency to prefer crop to livestock farms; (3) the use of professional managers with large-scale operations; and (4) the possibility of more frequent purchases of whole farms rather than "add-on" units.[14/]

The availability of credit probably is second only to economies of size considerations as a factor influencing land prices and the size of tracts being purchased. Since a "haven for foreign capital" is one of the reasons often given for foreign interest in purchasing land, it can be argued that credit restrictions would be more of a consideration for the domestic buyers. The limited data available are evaluated in an attempt to better understand the role of credit availability in land purchases.

In summary, the highly interrelated questions of price, size, and credit are subjected to empirical analysis to determine the probable impact of foreign investments in farmland. Although lack of data tend to prevent

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[13/] Stanton's (65) selection of the farm size question as the focus for his presidential address to the American Agricultural Economics Association in 1978 is indicative of the current interest in this public policy issue.

[14/] The possibility that foreign buyers purchase larger-than-average-size tracts cannot be translated to mean that the foreign investor is a major force in decreasing the total number of farms. The impact of farm consolidation by domestic purchasers also must be considered.

the arriving at definitive answers, the information developed should prove useful in evaluating conflicting claims about the impact of foreign investments on the U.S. farmland market.

Investments in Improving and Conserving Land and Tenure Arrangements

A topic that has long interested the researcher as well as the general public is the impact of farm tenancy on the farm sector because of its relationship to the deeply held rural value of family farm ownership.[15/] The approach here is to examine the phenomena of tenancy in the farm sector, with special emphasis on land improvements and conservation.

An often-expressed concern about a high rate of tenancy is that the tenant farmer and his/her family lack interest in and fail to participate in the "life" of the rural community and do not support the local economy. The economic interdependences between the farming sector and the local economy are examined in substantial detail in a subsequent section; the discussion of the noneconomic impacts is limited in this section to concerns about the participation of the farmer and his family in the educational, social, cultural, and recreational activities of the rural community.

Gaffney (30) indicates that Udell has "demonstrated the dereliction of absentee owners and branch plant managers in local charities, philanthropies and other civic good works" (p. 156). The question of whether the record of foreign absentee owners is any better or indeed even worse remains.[16/]

Rodefeld (56) has examined a substantial number of studies which generally examine the relationship between farm size, tenancy, and other factors which, in turn, tend to be associated with foreign investments in land. He finds that the impacts on the community are negative, but concludes that it is not possible to generalize the findings of the case studies presented as evidence to" . . . . other regions, types of productions and the present time period . . . ." (p. 87).

A related argument is that tenancy in general and foreign ownership specifically will cause a decline in conservation and a reduction in money spent in maintaining and improving the farm.

[15/] The separation between ownership-management and labor in other industrial sectors is widely accepted, but the goal of attaining the dual role of owner-operator is the norm in the agricultural sector.

[16/] An article in The Peoria Journal Star (July 7, 1978) personalizes this issue in discussing the firing of a manager after a foreigner purchased the farm. The dismissed manager dropped out of several activities of his church and civic organizations such as Rotary Club and Boy Scouts. However, for a valid comparison, the community participation record of the new manager also would need to be examined.

The potentially shorter planning horizon for tenants (whether the land is foreign or domestically owned) may indeed be a rationale for less interest in conservation. Johnson (42) found in a study of rental practices in two selected areas of Michigan and Illinois that 90 percent of leases are for 1 year and that two-thirds of the leases are verbal agreements. The effective length of lease, however, averaged 11 years in Michigan and 14 years in Illinois.

A recent study (45) of the Palouse area in the state of Washington concludes that the " . . . . damage to farmland from soil erosion is perceived as a substantially greater problem to farmers than absentee landowners . . . ." (p. 21). However, the authors also conclude that ". . . . the absentee owners appear more supportive of erosion control than farmers . . . ." (p. 25). Thus, conclusions about the relationship between absentee ownership and the level of conservation are not possible on the basis of this study.

A factor that has not attracted much public attention but which may indeed be one of the more significant impacts of foreign investments is related to distributional consequences of various public programs affecting land.

Researchers have amply documented the fact that at least a portion of the payments for acreage allotments in farm programs is capitalized into the price of land. These studies include the classic work in the 1950's on the effect of tobacco allotments (49) and the more recent studies of the impact of changes in peanut acreage allotment on the economic rent to land (14).

The impacts of new or increased acreage allotments will be "windfalls" or a direct subsidy to the foreign investor. The magnitude of these capitalized values can indeed be sizeable, i.e., the value of tobacco allotment (not including land or buildings) in the study referred to above ranged from $1,600 to $2,500 per acre in 1957. Although one might argue that the likelihood of enacting similar farm programs in the future is not great, the potential for large direct subsidies to the foreign investor through farm programs is a distinct possibility. Conversely, a major reduction in acreage allotments would result in losses to the foreign investor.

The same argument can be applied to natural resource development projects which are developed at less than full cost to the landowner. Abstracting from the basic question of societal gains or losses from such large-scale projects as those developed by the Bureau of Reclamation or the Corps of Engineers, most researchers would agree that there is a positive distributional effect to the owners of land in the project area.[17]

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[17] The work of Eckstein (22), Krutilla and Eckstein (44), and Haveman (35) all examine the distribution impact associated with natural resource investments. Also see the study of Infanger and Butcher (36) which estimates the income redistributional impacts of public-provided irrigation on individual income classes.

For our purposes, the important point is that public expenditures of funds in these activities enhance the value of the land asset. It is for the policymakers to decide whether it is desirable for the foreign investors to receive these gains. If the answer is no, it can be considered a negative, and on occasion a substantial, impact of land sales to foreign investors.

In summary, the conceptual issues in addressing the questions of tenancy and investment in conservation and improvements of the land are crucial to examining the impact of foreign investments in land. However, the importance of using "with and without" rather than "before and after" methodologies again need to be stressed. One cannot assume that all transfers to foreign interests are from owner-operator farmers, because some will be from local nonfarm owners and others from nonlocal absentee owners. The probable impacts of a transfer of farmland from an absentee owner to a foreign investor may be quite different than if the previous owner was an owner-operator. The lack of data prevent the empirical measurement of these differences, but it is important to note conceptual differences.

Land Use, Agricultural Production, and Farm Income

The issues that must be addressed are: (1) how foreign ownership influences the manner in which farmland is used and (2) what are the impacts of these land use decisions on farm production and income?

An often-repeated argument is that owner-operators are concerned about returns to both land and labor, whereas absentee (including foreign) owners are interested only in the returns to the land resource (19). This argument, reinforced by the contention that the foreign investors are less able and perhaps less interested in providing direct supervision over their investment, results in the conclusion that foreign ownership means less intensive use of the land. Although data to specifically refute or accept these hypotheses are not available, information related to this question is discussed in the analytical section of this report. At this point, it is sufficient to indicate that the data generally support the observation that foreign investors use leases similar to those of domestic owners within a given area.

An alternative argument supports the potential for more intensive use on tracts held by foreign investors or other absentee owners. It can be hypothesized that a tenant with a short-term planning horizon would seek to use the land in a more intense manner. For example, the tenant on a farm in the Midwest with a 1- to 2-year least may prefer to plant as much of the acreage as possible in corn while the operator with a longer planning horizon would more likely be amenable to a less-intense crop rotation pattern. Again, this is not a conceptual problem, but rather one which can be tested empirically when sufficient data are made available.

A final consideration when examining the question of intensity of use is the indeterminant effect of using hired managers rather than tenants on the absentee-owned land. The question is whether hired managers have and

use more specialized skills, which in turn, may affect the intensity of land use. The problem is the need to separate the impacts resulting from structural changes associated with larger size farms and those due to foreign ownership *per se*.

Questions concerning the level and distribution of agricultural production and farm income are substantially dependent on findings of the previously discussed factors. That is, they are "outputs" which depend on the "input" decisions affected by price, size, availability of credit, tenure and conservation, and land improvement expenditures. Thus, any meaningful examination of the farm production and income impacts will be limited to *if-then*-type statements, i.e., *if* the "input" factors are set at a specific level, *then* the production and income probably will change in a certain way.

Additional Considerations

There are additional factors which need to be considered when analyzing the impacts of foreign investments in farmland.

Although expressed in different ways, the single most important consideration in the mind of many is that increased sales to foreign investors represents one more step in the loss of a highly valued agrarian ideal.

Timmons (70) indicates that the reaction against the feudal tenure system familiar to our forefathers from Western Europe resulted in the development of a tenure system which emphasized individual freedoms--freedoms normally associated with farmers in an owner-operator status. Jefferson epitomized this approach and viewed agriculture not as a source of wealth but as the basis for human virtues and traits which were congenial to self-government (57).[18]

The point is that family farming is not viewed only as a business but also as a way of life. From this perspective, any action which affects this concept of farming is defined as a negative impact on society. The magnitude of the impact depends, in turn, on the particular values held by the individual performing the analysis.

Another intangible factor is the impact of foreign investments on the image of the United States within the world. One can argue that there is a positive benefit from foreign ownership, because these investors will tend to promote the image of the United States for psychological reasons. Conversely, these supposed gains must be weighed against the potential for external interference in domestic U.S. policies. At the extreme, foreign

[18] Barkley and Rogers (3) suggest that "Jefferson and his contemporaries were mixing good political science with poor economics when they suggested that the best organizational form for a constitutional democracy was one in which power was broadly diffused and in which the majority of individuals resided and worked on subsistence farming units that were essentially self-sufficient" (p. 24).

investments in U.S. farmland could be used as an excuse for foreign intervention to protect the property of that nation's citizens. The determination of the positive or negative balance from these counter-acting forces must be left to the individual or to policymakers as their representatives.

Another unknown is the degree to which other nations may respond to more stringent U.S. restriction on foreign land ownership (27).[19/] The importance of this concern is reinforced by the Department of Commerce estimates (1976 data) which indicate that the book value of U.S. investments abroad is some 4.5 times the value of all foreign investments in the United States. Although not directly measureable, the potential for reciprocal action by foreign nations if the United States should decide to restrict foreign investments in farmland needs to be considered in estimating positive and negative impacts.

A final concern, discussed briefly by Gaffney (30), is the need to consider the cost of implementing a program designed to prevent foreigners from investing in farmland. Even if one assumes the burden of reporting is placed on the foreign investor, the administrative cost (including policing for compliance) needs to be included in the final accounting of the costs and benefits of controlling foreign investments in farmland.

In summary, this section presents the conceptual arguments used in discussing the impacts of foreign investment in farmland. In general, most of the conceptual considerations which are subject to economic analysis are fairly straightforward. Even the arguments based on values are a bit clearer if one is forced to focus on specific concerns rather than vague generalities.

MEASUREMENT OF FOREIGN INVESTMENT IMPACTS ON U.S. FARMLAND

The objective in this section is to determine what analytical/empirical measures are available to help address the issues raised in the previous section. The organizational arrangement within the section is to: (1) outline the major data sources available; (2) sketch out the general magnitude of the problem by examining the amount of farmland available for sale and the amount being sold to foreign investors; and (3) focus in on eight specific issues of concern in measuring the economic impact of foreign investment in U.S. farmland.

Data Sources

In terms of recent studies, the benchmark data are from a 1975 survey in which the Department of Commerce attempted to survey all 6,000 foreign firms and individuals with direct investment in the United States (79).

[19/] Some argue that "in the name of fair play" we should prohibit foreign investments in the United States by citizens from any country which prohibits foreign ownership of farmland in their country.

This analysis found that about 4.9 million acres of land (not all farmland) are held by foreign investors. However, this estimate may be understated because a criterion for being included in the survey was that the foreigner own at least 200 acres. Even allowing for substantial underestimation, the estimate of slightly less than 5.0 million acres is a very small percentage of the 1.3 billion acres of private land in the United States (76). Thus, the Commerce study provides generalized estimates, but the data lack the specificity needed, (i.e., details on a State or regional basis or amount that is actually farmland) for detailed economic analysis.

In an attempt to develop more specific information, the General Accounting Office (GAO) conducted a survey of foreign ownership of farmland in 25 counties located in 5 States. Their report, aptly titled Foreign Ownership of U.S. Farmland--Much Concern, Little Data (80) added some insights but lacks the broad base needed to generalize the findings to other regions. As in other studies, the authors emphasized that their estimates were not particularly reliable, but the study does have the advantage of including only confirmed instances of foreign ownership.

A third attempt to gain better measures of the extent of foreign investment in U.S. farmland involved a study requested by Senator Talmadge of the Senate Agriculture Committee. The targeted respondents in this survey were members of the Cooperative Extension Service and personnel from USDA's Agricultural Stabilization and Conservation Service in each of the 50 States. The findings of this study, the most comprehensive to date, were published in a recent (January 1979) report of the Senate Committee on Agriculture, Nutrition and Forestry (63).

A fourth study, conducted specifically in support of the analysis for this report, is a followup survey to the Talmadge study designed to attain more detailed data from Extension personnel in counties reporting a higher-than-average level of foreign investment activity. This information was supplemented by data collected in a telephone survey from a small number of brokers or agents known to work with foreign investor clientele.

The specifics of the methodology and scope of the first three studies are readily available in the referenced documents. Since the fourth study is unpublished, the general characteristics of this work are briefly outlined here.

A request was made to extension personnel in a total of 31 counties in 18 States. An attempt was made to include States in all regions of the Nation. Responses to a mail questionnaire was received from 24 counties in 14 States, with an equal number of responses from the southern region, and the northern and western regions.[20] The information received was

[20] Specifically, respondents from the southern region included counties in Alabama, Arkansas, Georgia, Louisiana, Maryland, Missouri, and North Carolina. Similar data for the north and west are from Iowa, New Mexico, New York, Ohio, Oregon, Texas, and Vermont.

based on the respondents' knowledge of conditions in a specific county. Most counties had sales of more than one tract--in fact, the information from the 24 counties was based on a total of 118 transactions (an average of nearly 5 transactions per county), with 78 sales occurring in the southern region and 40 in the north and west.

The above four studies account for the bulk of the empirical data available, on a nationwide basis, which deal directly with the question of foreign investments in U.S. farmland.[21]

Before proceeding to an analysis of specific attributes of the foreign investors holdings of farmland, it is useful to place in perspective, based on the above referenced sources, the magnitude of "the problem."

Problem Setting

The physical supply of land in the United States is estimated to be 2,264 million acres (77). Nearly one-fifth of the total area is cropland, slightly more than one-fourth is permanent grassland and range, almost one-third is forest land, and the remaining one-fifth includes special-use areas such as mountains, deserts, and swamps.

For purposes of analyzing the problem at hand, the focus is on the 465 million acres designated as cropland and the 600 million acres in grassland pasture and range. Except for minor definitional differences, these two use categories add up to the estimated 1,068 million acres of land in farms reported for 1978 (77).

The "outer boundary" of the acreage of farmland available for sale to foreign investors is somewhat less than the one-billion-plus acres of land in farms. The reason is that, although virtually all cropland is privately owned, only about two-thirds of the grassland pasture and range is in private ownership. Thus, there is an upward bias in the estimate of the total farmland available which should be recognized when interpreting the following empirical information (table 1). If one adjusts for this bias by deleting publicly held land (under the assumption that Federal, State, and other owners are not selling the land under their control), the ratio of land transfer to total land in farms would increase slightly.

The data in table 1, even with their limitations, indicate that about 2.3 percent of U.S. farmland is being transferred each year. Thus, it would take, on the average, slightly over 40 years for land to turn over "in the

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[21] There is a limited number of additional studies which provide data for limited geographic areas. For example, see the Currie, et al., study of investments in Iowa farmland (18), the Gertel's investigation of foreign investment in Hawaiian real estate (31), Schmedeman's examination of foreign investment activity in the Texas and surrounding areas (60), and Waples study (with Munger) in Colorado and Arizona (81).

Table 1--Total land in farms, acres of farm real estate transferred, and acres sold to foreign investors, 1978

	Acres in farms 1/	Acres of farmland transferred 2/		Acres of farmland sold to foreign investors 3/	
	Thousands	Thousands	% all land	No.	% land sold
Northeast	30,943	782	2.5	40,536	5.2
Lake States	61,000	1,255	2.1	16,712	1.3
Corn Belt	129,500	2,801	2.2	43,443	1.6
N. Plains	183,700	2,006	1.0	27.929	1.4
Appalachian	57,700	1,973	3.4	37,882	1.9
Southeast	53,100	1,206	2.3	61,475	5.1
Delta	44,600	1,209	2.7	58,559	4.8
S. Plains	176,500	3,202	1.8	65,873	2.1
Mountain	261,900	8,008	3.1	81,553	1.0
Pacific	69,400	2,405	3.5	107,284	4.4

1/ Preliminary data for 1978, Farm Real Estate Market Developments, (78).
2/ Same source as footnote 1, data for year ending March 1978.
3/ Source: Foreign Investment in United States Agricultural Land, (63).

market," even if one assumes none of the land is resold.[22] The regional distribution of sales suggests a relatively stable pattern, with the Appalachian and Pacific areas showing a higher than average ratio of sales, while a low ratio of sales is found in the Northern and Southern Plains States.

22/ The data in table 1 on areas of farmland transferred are for the year ending March 1, 1978, but a check of other years indicates a relatively stable pattern over time. Data on acres of farmland sold to foreign investors are calculated as an annual equivalent of the sales to foreigners for the 18 month period of January 1, 1977 to June 30, 1978.

Of specific interest is the estimate that 2.2 percent of all farmland acreage sold is purchased by foreign investors. These estimates are based on Small's (63) evaluation of responses to the Talmadge survey and provide the best information available on the current rate and distribution of foreign investment in U.S. farmland.[23/]

Somewhat surprisingly, the ratio of all farmland sold to foreign sales is highest in the Northeast and relatively low in the Corn Belt region. While recognizing that there are areas of prime land in all regions, this finding suggests the need to question the public's perception that foreigners are buying only prime land in the most productive agricultural areas. Unfortunately, data on the quality of land purchased by foreign investors is not currently available.

The heaviest concentration of foreign investment in farmland is in the southern region plus a few States in other regions. It is useful to note, for example, that the Talmadge survey found that nearly 90 percent of all farm acreage purchased by foreigners was concentrated in 20 States. Of this amount, 46 percent of the farmland and 59 percent of the cropland acreage purchased by foreigners was in southern states--Texas, Georgia, Louisiana, Arkansas, Florida, Mississippi, and South Carolina. Using an alternative benchmark, the percentage annual foreign purchases are of the total amount of farmland equals or exceeds 0.2 percent in Oregon, Louisiana, Vermont, Georgia, Florida, Maryland, and South Carolina.[24/]

To recap and help place these numbers in perspective, one can say that for each 1,000 acres of farmland in 1978 about 23 acres were transferred to a new owner. Further, of each 23 acres, about 0.5 acre was transferred to foreign ownership--assuming that all land purchased by the foreign interests was owned by U.S. citizens.[25/] Thus, it seems safe to assume that, under current conditions, the amount of land being sold to foreign investors is relatively insignificant.

The other question which needs to be addressed is how much farmland is already in foreign hands. The data here are very weak because of the ease with which foreign ownership can be concealed. The degree of concealment may be high because it is thought that many foreign owners desire secrecy, and a centralized record-keeping system is not available to check on landownership. The best estimate is that slightly under 5 million United

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[23/] See Small's (63) article in the Senate report for the specific methodology. In general, if there were major differences in estimates provided by the ASCS and the Extension Service, the higher estimate was used.

[24/] The high ranking of Oregon is influenced by the foreign purchase of two very large ranches during the survey period.

[25/] Even in the Northeast, where the general sales level and the percentage of sales to foreigners is higher, a total of 1.3 acres of each 1,000 acres of land would be transferred to foreign ownership.

States acres were owned by foreign interests in 1975 (75).[26/] It is assumed that a majority of the land would be farmland. In any case, the total amount of foreign ownership probably is well under 1 percent of the total farmland acreage. The more limited GAO study of 25 counties in 5 States found that the percentage of foreign ownership in the five States (extrapolated on bases of counties investigated) was: California, 0.1 percent; Georgia, 1.5 percent; Kansas, 0.3 percent; and none in Missouri or Oklahoma.

In summary, the level of current holdings of U.S. farmland by foreigners and the rate at which additions are being made to this ownership base indicates that in absolute terms the level of foreign ownership is very small. The potential for foreign domination of the farm real estate market in any State seems very unlikely unless there are major shifts in the present rate of foreign investments. It is important that the discussion of concerns about the specific impacts of foreign investments in the following section should be viewed within this context.

Specific Economic Issues

Eight economic areas are examined as they relate to the impact of foreign investments in U.S. farmland. Specifically, these include: (1) price; (2) size of farms; (3) availability of capital; (4) land use; (5) investment and maintenance of farm assets; (6) land tenure; (7) agricultural production; and (8) farm income. Since several of these attributes are highly interrelated, the items are combined into more general categories. The first category includes the question of what factors affect the supply, demand, and price of farmland. The second category relates to questions of tenure arrangements and amount spent for maintaining and improving the farms. Factors in the third category focus on farm output characteristics and include land use, agricultural production, and farm-income characteristics.

Price of Farmland

The two basic questions which need to be addressed are: (1) what is the trend in the price of farmland; and (2) what is the impact of foreign investments in land on this trend?

The first question is relatively easy to answer because of the excellent information provided on a continuing basis by USDA researchers (78). The information in table 2 shows a significant upward trend in the value per acre of farm real estate over the past 10 years. More specifically, farmland prices tripled in the 1968-78 decade, while in the Corn Belt and Northeast the indices suggest a push toward a fourfold increase in values

[26/] Forthcoming data from the Census of Agriculture and the registration requirements from the new Federal legislation should provide a much more accurate estimate of total foreign ownership.

Table 2--Index of per acre average value of farm real estate, 1968, 1973, and 1978 (1967=100) [1/]

Region	1968	1973	1978
Northeast	109	189	375
Lake States	105	158	360
Corn Belt	106	142	372
Northern Plains	107	139	317
Appalachian	109	173	326
Southeast	109	176	309
Delta States	109	150	253
Southern Plains	109	153	268
Mountain	105	156	316
New Mexico	109	177	280
Pacific	109	149	233
Avg.[2/]	107	150	308

[1/] Source: USDA, Farm Real Estate Market Developments, (78), p. 18. Regional indices based on unweighted State averages.

[2/] Excludes Alaska and Hawaii.

within this time period. In absolute terms, the national average value per acre in 1978 was $490, with a range from a low of $93 per acre in New Mexico to a high of $2,057 per acre in New Jersey.

The fact that farmland prices are increasing is readily apparent. The more difficult question is whether the relatively small number of foreign purchasers, even in States where foreign investors are most active, are a significant factor in influencing this price increase. Since the public's perception is that foreign buyers do drive up the price of land

because they pay more than the "going rate" for land, it is necessary to examine the major forces in the farmland market today.[27]

The dominant force increasing farmland prices is the desire for current operators to increase the size of their holdings. Purchases for farm enlargement accounted for 58 percent of all farm purchases in 1978, compared with only 29 percent in 1954 (78). Using another approach, if one limits the analysis to tracts that were complete farms before the sale, 53 percent were bought to continue operation as a full-time farm while 42 percent would become part of another farm. Continuing the analysis, if one starts with tracts that were operated as part of another farm before the sale, then 80 percent of the tracts will continue to be operated in such a manner and only 11 percent would revert to a complete farm operation. Thus, the push for farm consolidation and its impact on price must be considered a major force in the upward trend in farmland prices.

A second major factor in increasing the price of land is real and perceived inflationary pressures. USDA researchers comment that: "Land value changes during the 1970's so outpaced the changes in net farm income that it was common to separate the return on investment into that derived by the income-generating power of the land and that derived from appreciation in land values" (78, p. 6). Over the past 20 years, there has been a 2-percent increase in land values for each 1-percent rise in the consumer price index. The point is that inflation, especially inflation in farmland prices, provides a continuous upward push to land prices. The relatively insignificant level of foreign purchases of land is relatively minor when compared with these domestic economic forces.

The question remains, however, if the foreign purchasers pay more than domestic purchasers for the same type of land, in the same area, at the same time.[28] In some cases, foreign investors seem to pay more while in others they seem to be paying less.

The Iowa study (18) found that the prices paid were not a concern or a limiting factor for foreign investors. They paid prices at the top of

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[27] This discussion of forces affecting the price of land draws heavily on the "outlook section" in USDA's Farm Real Estate Market Developments, (78), pp. 4-7.

[28] Some would argue that "for the same purpose" should be added to these *ceteris paribus* conditions, i.e., if the domestic buyer is principally buying incremental additions to a present farm base and the foreign investors are purchasing a whole farm, the prices being paid for the smaller tracts purchased by the domestic buyer will tend to be overstated in direct comparisons.

or somewhat above the fair market value of good quality land in the area. All foreign investors wanted only top-quality land.[29/]

Some critics of foreign investment in farmland claim that foreign investors often pay 50 percent above the market price or on occasion pay 2 or 3 times the going price for a parcel of land. The GAO (80) researchers unearthed some hearsay evidence in their study but were unable to confirm or refute it. In only one instance could the GAO researchers determine empirically if a foreign investor had paid more or less for a tract of land. In this specific case, the foreign investor was found to have paid about $40 an acre less than domestic purchases for comparable sales.

The survey by Extension personnel conducted as part of this study (24 counties in 14 States) supports the contention that foreign buyers do indeed pay higher than "market price" for their purchases. Specifically, in the 24 counties for which survey data are available, the response to the question of whether foreign purchasers paid prices higher, lower, or in line with the current market price, was: 54 percent higher, 38 percent in line with, and 8 percent price not available. No response indicated that lower-than-market prices were paid by foreign investors. These results need to be used with caution. For example, one respondent indicated the foreign investor paid 30 to 50 percent more than the market price for a farm, but 6 months later the level of the land market had reached the price paid by the foreign investor.[30/] It is important to emphasize, however, that when only 2 to 3 percent of the land is transferred in a given year, it is difficult to establish a benchmark market price for comparison purposes.

In summary, there is some evidence that the foreign demand for land does provide an upward force on farmland prices. However, the size of the foreign investment component, when compared with the total market, is so small that the overall impact of foreign investments on price probably is minimal.

Size of Farm

The questions concerning the size of farms are very similar, and highly related to, the concerns about price. That is, are farms becoming larger and why--and what is the role of foreign investment in the changes in farm

[29/] Paulsen (56) makes the point that in Germany farmland is seldom sold but passes from one generation to the next. In addition, he suggests that farmland with only 20 percent available for cultivation sells for $3,200 per acre while better farmland, with no development potential, sells in the $6,500 per acre range.

[30/] A similar phenomenon was reported on a November 19, 1978 CBS "60 Minutes" program on foreign investment in U.S. farmland.

size? The following data indicate a gradual but sustained increase in the size of farms over the past decade. The relevant question is, therefore, why is the size of farms increasing?

Year	Ave. size of farm	Year	Ave. size of farm
1969	369	1974	388
1970	374	1975	391
1971	378	1976	394
1972	382	1977	397
1973	385	1978	400

Source: USDA, 1978 Agricultural Statistics, (77), p. 417.

Several studies have analyzed the question of whether there are significant advantages to be gained through economies of size in farming. Brewster and Wunderlich (10) argue that except in specialized livestock and poultry production, "technology soon reaches biological and spatial limits." Madden and Partenheimer (48) argue that most economies of size can be attained within a one- or two-man family farm operation. Conversely, Sundquist (67) found that for farms in the North Central States, a 1,200-acre farm would be more efficient than the average 374-acre farm in the region, on the basis of cost per unit of production.

More recent studies seem to support the contention that there are significant economies available from increases in the size of the farming operation. One of the more interesting was a study by Krause and Kyle (43) which measured the costs and returns from corn production in units of 500- to 5,000-acre units when measured against a 500-acre reference unit.[31/] Using a 10-percent capital charge, these data would suggest that the price paid for land in the larger operation could exceed that paid for land used in the 500-acre base operation by as much as $73 per acre.

There are only a limited number of statistics available for directly evaluating the impact of foreign investment on farm size. Small's (63) summary of the Talmadge survey, for 16 States in which data were available, reported the unweighted ratio of the size of tract purchases by foreign investors was 8.9 times the size of the average tract sold (p. 84). Due to the wide variation among the States, a more realistic measure of the

[31/] For additional discussion of the size-price relationship, see the work of Harris and Nehring (34), Whitmore's comment (84), and the original author's reply (34).

magnitude of the size of tracts purchased by foreigners should be based on the median value of 3.9. In either case, the fact seems to support the public's perception that foreign investors buy larger-than-average-size farms. However, the evidence available which suggests that foreigners tend to purchase complete farms, whereas domestic buyers focus on tracts for farm enlargement, needs to be considered when making this comparison.

USDA reports (78) indicate that sellers are becoming increasingly aware that there is the potential for higher prices if their farm is sold in smaller tracts rather than as a whole unit. The percentage of all tracts sold as parts of farms increased from 22 percent in 1954 to 45 percent in 1978. Statistics on farm sales in the highly productive Corn Belt region show that sales for farm enlargement accounted for 75 percent of all sales. The evidence seems to suggest that the size of tracts sold to domestic buyers is smaller than those sold to foreign buyers, but a sizeable portion of these sales was for farm enlargement.

In summary, it seems clear that the economies of size advantage gained through domestic sales for farm enlargement is the driving force in increasing the size and price of farmland, and probably a leading factor in decreasing the number of farms. The impact of sales to foreign investors on farm size probably is minimal.

Role of Credit

Returning again to the most current source of farm real estate information, the USDA (78) reports that in 1978 a record 89 percent of all farm transfers of 10 or more acres were credit-financed with an average debt-to-purchase-price ratio of 76 percent. Data for 1978 indicate that a substantial increase in the use of credit "tightened the market" and increased the interest rates, but USDA researchers generally conclude that "real estate financing does not appear to be a problem" (p. 41).[32/]

Because of the importance of the credit question, more information on the financing behavior of foreign investors was collected (by phone survey) from seven brokers and/or agents known to be working with foreign investors in farmland. Although some may argue about the reliability of these data because of the size of the sample and the potential for a "self-interest bias" in the responses, it is the best information available on this important question.

The responses to the question of the percent of the purchase price financed with U.S. funds resulted in mixed results. Responses that the amount of

[32/] Current (1978) information (78) indicates that seller financing is the most common source of funds for domestic farm purchases. Federal Land Banks rank second in terms of market share of new loan funds for farmland, followed by life insurance companies, Farmers Home Administration, production credit associations, and savings and loan associations.

loan funds ranged from zero (100-percent foreign funds) to 75-percent financing from U.S. loans is indicative of the lack of a typical arrangement. Four of seven respondents indicated that at least 50 percent of foreign purchasers wanted no U.S. financing. An area of general agreement was that the use of U.S. funds often was at the insistence of the seller for tax and other reasons.

A second general conclusion was that the foreign investors are interested in a high-equity position, often in excess of 50 percent. The rationale for the desired high level of equity includes: (1) adverse to high risk; (2) wants sufficient equity to cover debt service and other farm expenses; and (3) investor uses purchase of land as a vehicle for transferring money to the United States.

The question of whether the U.S. loan funds were from within or outside the local community also resulted in the lack of a typical arrangement. Although it is extremely difficult to generalize, about one-half of the U.S. money for foreign purchases seemed to come from within the local community and one-half from outside the community (usually insurance companies).

When respondents were asked the more specific question of what is the source of the within-community loan funds, the level of agreement was much higher. There was virtually unanimous agreement that the source of local funds was from the seller of the land and the loan was almost always made at the request of the seller.

Two additional issues relate to the credit availability question. First is the fact that there has been a major shift in inputs within the farming sector. Nikolitch (54) discusses the shift in the resource inputs in agriculture and indicates that between the end of World War II and the early 1970's, 70-percent less labor was used on farms to produce a third more food and fiber. Most of this shift in inputs was from labor to capital.

A second observation is that there is some evidence that the renting of land is being used to meet capital limitations. For example, Johnson reports (41) that in the aggregate (and generally following the same pattern within each census region) 46 percent of the land in Class I, but only 28 percent of the Class V land, is rented (p. 26). Additionally, the percentage of land rented tends to be high in the productive Corn Belt region, where average land values are high.

In summary, the major force affecting the increasing price of land and size of farms is the desire by farmers to enlarge the size of their operation to gain economies of size advantages. Further, although credit is becoming somewhat more expensive, the lack of loan money does not seem to be caused by the foreign investors or to significantly impact on the market for farmland.

Improving and Conserving Land and Tenure Arrangements

Due to definitional changes, it is difficult to trace changes in the percentage of farms being operated by tenants. According to USDA (37) estimates, the acreage being farmed by tenants has been decreasing gradually and in 1974 was 12 percent. However, a great deal more than 12 percent of all farmland is rented, with the majority being farmed by part-owners who operate the land they own as well as renting additional land from others. Johnson (41) found that nearly 40 percent (400 million of the slightly more than 1 billion acres of land in farms) was rented and that two-thirds of this land is rented to part-owners.

Of more relevance for this study is the question of who owns the land being rented. The Johnson (41) analysis indicates that nearly 90 percent of the land is rented from nonfarm landlords.[33/] However, this high percentage is at least partly a function of the definition of "nonfarm landlords" used in the analysis, i.e., the acreage was assumed rented from a nonfarm landlord if the owner was not currently operating a farm. Thus, renting from a retired farmer or a widow of a farmer was defined as renting from a nonfarm landlord. Additionally, it was reported that one out of every three farm operators renting farmland was leasing at least some of the land from a relative. A more in-depth study (42) of the characteristics of renters from two selected areas in Illinois and Michigan reported that 38 percent of the landlords were related to tenants.

This same study, although limited in scope to two areas in the north-central region of the country, also provided useful insights into the occupation and residence of the landlords. The occupation data for the year 1971 were as follows:

Landlord occupation	Michigan location (Percent)	Illinois location (Percent)
Retired farmer	46	26
Widow of farmer	30	37
Active farmer	3	5
Nonfarm businessman	12	12
Retired nonfarmer	5	11
Other	4	9
	100	100

This study, admittedly in a limited area, indicates that nearly 80 percent of the Michigan and 70 percent of the Illinois rented lands are in a very

[33/] The percentage of value of land rented is the same because of an assumption in his study that the per-acre value of farmland from farm and nonfarm landlords is identical.

real sense part of the agricultural establishment. Thus, when discussing the impact of tenancy, it must be remembered that, to a large extent, it is a distribution of impacts among various participants within the agricultural sector.

A second useful result from this same study, and subject to the same limitations, is the location of the residence of the landlords:

Landlord residence	Michigan location (Percent)	Illinois location (Percent)
On property	66	20
Nearby farm	8	13
Nearby town	16	52
Out of county	2	5
Out of State	8	10
	100	100

There are severe limitations in generalizing from a single case study, but it is useful to note that in this study 15 percent or less of the landlords lived out of the county in which the property was located and 10 percent or less out of the State. When viewed in combination with the occupation data above, this suggests that most of the impacts associated with tenure arrangements are localized, largely within the agricultural sector.

In an attempt to determine the tenure arrangements associated with foreign investors, the survey of both the Extension personnel and the brokers and agents contained a question on tenure.

Four of seven broker/agents suggested a tenant farmer as the most common arrangement, two suggested hired manager, and one respondent indicated about equal representation (55 percent manager and 45 percent tenants). For tenants, the crop-share lease seems to be slightly more common, but in most cases the tenancy pattern follows the typical operating arrangements in the community. There was nearly complete agreement that the larger properties tend to have hired managers, while the smaller holdings are more likely to be tenant operated.

Reports from the Extension workers produced somewhat different results. They indicated that the hired manager is the most common tenure arrangement, accounting for about 50 percent of the total. A tenant farmer was reported on about 40 percent of the foreign-purchased farms, with about three-fourths of these being under a crop-share or crop-share-plus-cash lease, and the other one-fourth working under a cash-lease agreement. The remaining 10 percent of the respondents failed to answer the question or indicated that the foreign purchaser or a member of his/her family would occupy the land.

Although it is not possible to verify the information, it would seem that a hired manager is a bit more common than a tenant on foreign-owned land.[34/] This, in turn, would suggest somewhat more separation between the farm worker and management decisions and thus have a negative impact on the "family-farm ideal."[35/]

A closely related concern is whether tenure arrangements on the foreign-owned land are associated with a decrease in the conservation and improvement of the land resource.

Until recently, it was virtually impossible to address the broader question of the level of conservation and capital improvement expenditures by U.S. farmers. Fortunately, a March 1979 study by USDA ESCS (24) provided a breakthrough by providing time-series estimates of the aggregate level of net investments in major conservation and development activities.

Information in table 3 provides an overview of the level and distribution of net investments in land and agriculturally related activities in 1975. Net investments in natural resources are estimated at $27.5 billion or about 8.5 percent of the total value of land and other physical capital in farming.

The information in table 4 provides a historical record of the average annual net Federal investment in natural resources. Using data for the most current time period, 1971-75, a net value of some $30 million per year is being invested by the Federal Government in natural resource conservation and development. Since the percentage of all land being purchased by foreigners is very small, the direct transfer of the benefits of these programs to foreign investors is relatively small. However, the distributional impacts resulting from these programs may become important if the percentage of foreign purchases is significantly increased.

Another issue which needs to be considered is the magnitude of the benefits from farm programs which are capitalized into land values, which in turn,

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[34/] It should be noted, however, that the Iowa study (18) found that foreign investors used Iowa land for cash-grain operations much like domestic farmers. Generally, the foreign investors act as absentee owners, leasing the land to local operators or even leasing it back to the original owner.

[35/] Nikolitch (54) argues that "tenancy is compatable with family farms because in most instances tenants make day-to-day management decisions with little or no interference from landlords" (p. 250). He supports his argument with the observation that the Corn Belt is recognized for its high proportion of family farms, yet tenancy in this region is highest in the Nation. The important point being made by Nikolitch is that it is important to distinguish between "the concept of ownership of the farm business" and "ownership of the (farm) real estate."

Table 3--Value of and net investments in land and related agricultural activities, 1975*/

		Billions of 1972 Dollars	Percent
Value of land and other physical capital		325.6	100.0
Net value of land	172.1		52.8
Crop and livestock inv.	42.6		13.1
Fixed-capital investment	110.9		34.1
	325.6		
Fixed-capital investment		110.9	(34.1)
Residential farm structures	21.9		6.7
Nonresidential farm structures	29.0		8.9
Producer durable equip. (mach., etc.)	32.5		10.0
Natural-resource investments	27.5		8.5
	110.9		
Natural-resource investments		27.5	(8.5)
a) By source--			
Federal investments	12.3		3.8
Private and other nonfederal	15.2		4.7
	27.5		
b) By agricultural purpose--			
Irrigation	12.3		3.8
Drainage	5.5		1.7
Soil and water cons.	9.7		3.0
	27.5		

*/ ESCS staff, "Natural Resource Capital in U.S. Agriculture," (24), tables 1 (p. 23) and 3 (p. 25).

Table 4--Average annual net Federal investment in natural resources, 1931-75*/

Years	Ave. annual net investment, mils of 1972 dollars	Years	Ave. annual net investment, mils of 1972 dollars
1931-35	40	1956-60	170
1936-40	405	1961-65	250
1941-45	520	1966-70	225
1946-50	380	1971-75	30
1951-55	210		

*Source: ESCS staff, "Natural Resource Capital in U.S. Agriculture," (24), table 14, p. 36.

would be a "windfall" gain to the foreign purchaser. The problems involved in measuring the incidence of program benefits are extremely complex, and the reader is referred to a study by Reinsel and Krenz (58) for a methodological procedure.[36/] The following quote from their 1970 study provides an indication of the potential for a transfer of benefits to the foreign owner. They conclude that:

> Each year $4 billion to $5 billion is spent for real estate and these purchases represent about 2 percent of the land in farms. Some part of this expenditure is for the rights to program benefits. Assuming that programs have never represented more of the total value of real estate than in 1970--7.9 percent--the upper limit of what

[36/] Reinsel and Krenz (58) state that: "The distribution of total benefits among the factors of production depends on the price-quantity relationships for both inputs and outputs, nonprogram production alternatives, and nonfarm alternatives for the assets employed. If all factors had equal supply elasticities and were used in fixed proportions, each would receive a proportional share of income with or without programs. On the other hand, if supplies of all inputs except land were perfectly elastic and the land supply perfectly inelastic, all program benefits would be available for land. Neither of these extremes is likely, and program benefits will be shared by the several input factors in some intermediate proportion. Land will receive some part, but perhaps a lesser part of the total." (p. 4.).

> was paid to acquire benefits can be estimated. The estimate is obtained by multiplying the value of land transferred in any one year by 7.9 percent and summing over the years of purchase. If the true capitalization rate for benefits is 15 percent or higher, a land buyer would, in 15 years or less, recover 90 percent or more of what he paid. Thus, those who purchased benefits more than 15 years ago (before 1955) have, for all practical purposes, recovered their investment. Because of the appreciation in asset value that has occured, they are, in fact, receiving a windfall stream of income (p. 20).

The point is that there is the potential for a significant transfer of farm program benefits to the foreign investor. At current levels of foreign investment, the absolute level of these potential "windfalls" probably is relatively small. However, it may be an important consideration if foreign investment activity in farmland increases.

The only direct information available on the question of private foreign expenditures in farm-owned investments for conservation and development is available from Extension personnel in the followup to the Talmadge survey. The respondents were asked the question: "Has the foreign owner maintained, up-graded or neglected the land and improvements, e.g., farm drains, contours and terraces, fences and buildings?" The responses were: improve, 50 percent; no change, 38 percent; deteriorate, 4 percent; and no response, 8 percent. These results need to be interpreted with respect to the small number of observations, but these findings suggest that foreign owners are not exploiting the land and in fact are improving their land.

The major investments in land improvements being made by the foreign owners were in land-leveling, clearing, irrigation, and fencing. One respondent indicated foreign owners were improving the land but letting the buildings deteriorate.[37/]

Additional information available includes testimony of John Gornall, (an attorney who aids foreign investors in acquiring U.S. farmland) before the House Consumer, Commerce and Monetary Affairs Subcommittee (33) that foreigners often invest heavily in caring for soil, and rumors that foreign investors were taking farmland out of production were completely groudless.[38/] His views, as nearly all discussion on this topic, lack the empirical data to test for validity.

[37/] The Iowa study (18) reports that ". . . . in several cases where specific listed tracts were considered the transaction was not consumated because of the presence of buildings on the land" (p. 122).

[38/] Presumably, no pun intended.

In summary, an increase in foreign investments in U.S. farmland will increase the number of tenants and hired managers. To the extent this decreases the preferred structure of American Agriculture, it can be counted as a negative impact of foreign investment. This must be tempered by the fact that by far the largest group of "tenants" in agriculture is the part-owners who are renting land to increase the size of their farming operation. Answers to the question of whether foreign owners spend more or less on conservation and improvements must await the results of research. The limited data currently available suggest that foreign owners do receive good marks on soil stewardship.

Land Use, Agricultural Production, and Farm Income

The current level of foreign ownership is too small to have significant, measurable effects on the aggregate level of farm production and income in the United States. The analysis thus is developed in terms of probable impacts on land use, agricultural production, and farm income, if there is a substantial increase in foreign ownership of U.S. farmland.

Aggregate indices of the amount of cropland used for crops and farm output (table 5) for 1972 and 1977 show a current upsurge in cropland used for crops, with the largest increases being in the Delta and Southeast regions (77).[39/] Data are not available to test whether it is anything more than coincidence that these regions also experienced the highest rate of new foreign investment.

The index of farm output shows continually increasing farm output in all regions but the northeast. The estimated 20-percent increase in the index for the 1967-77 decade is a direct measure of the aggregate increase in farm production and is a proxy measure of the increase in the intensity of land use.

Information on the impact of foreign ownership on the intensity of land use was gleaned from three sources: (1) the Iowa study (18), which reported the pattern of land use had not changed with foreign ownership; (2) the GAO study (80), which found that foreign and domestic owners produced and marketed crops similarly; and (3) the "follow-up survey," which indicated no change or an increase in intensity of land use.

Two questions were asked of the survey respondents in the followup survey of Extension personnel. The first question was: "Has there been a change in land use (on foreign purchased farms) such as changes in crops grown or changes in the intensity and amount of production?" The majority (63 percent) of the survey respondents indicated there was no change in land use. In the remaining counties, 33 percent indicated an increase in the

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[39/] The recent increase in cropland used for crops is a reversal of a declining trend during the fifties and early sixties (76).

Table 5--Indices of cropland used for crops and farm output

	Index of cropland used for crops (1967=100)		Index of farm output (1967=100)	
	1972	1977	1972	1977
Northeast	92	99	90	98
Lake States	94	113	107	129
Corn Belt	96	112	105	116
N. Plains	99	107	121	126
Appalachian	99	117	105	111
Southeast	101	123	108	112
Delta	110	128	123	129
S. Plains	94	113	116	141
Mountain	103	106	110	113
Pacific	102	105	116	134
U.S.	98	111	110	121

Source: Agricultural Statistics, 1978 (77), p. 442.

intensity of land use, and only 4 percent indicated a decrease in intensity.[40/] Typical examples of the more intense use include: (1) clearing of land to plant crops; (2) irrigation of former dryland areas; and (3) change from native to improved pasture and alfalfa.

The view was different when the respondents were asked whether there had been a change in the kinds or amount of livestock (including hogs and poultry) and livestock products produced. More than 70 percent of the

[40/] The only respondent indicating a decrease in the intensity of land use reported that land formerly in crop production was being used in an intensive timber management program.

survey respondents indicated there was no change in the livestock enterprises. But slightly over 20 percent indicated a decrease in livestock, and only 8 percent reported an increase in the amount of livestock on the newly purchased foreign farms. Although the number of observations becomes very small, it is interesting to note that livestock production was completely eliminated on 60 percent of the farms reporting a decrease in livestock.

The importance of the "with and without" analytical framework should again be stressed. The question that needs to be addressed is whether the reported increase in land-use intensity and the decrease in livestock production would have occured if the sale had been to a domestic rather than foreign investor.

The impact of foreign ownership of U.S. farmland on the level of farm output and income simply is not known. The output (in physical or dollar terms) of the farm sector is determined on the basis of a host of previous input choice decisions; thus, until more information is available about these prior choices, it is somewhat meaningless to speculate about outcomes.

Two observations may be useful, however. First, the process by which land prices are bid up absorbs capital without increasing productivity. Additionally, it will tend to cause a change in the factor mix, i.e., as land prices increase, other inputs will tend to be substituted for the more expensive input. This would suggest an increase in production per acre and potentially an increase in farm output.

A second factor which should not be overlooked when examining the concept of farm income is that a large portion of the income of farm operator families is from off-farm sources. In 1977, the income of the farm operator and his/her family totaled nearly $52 billion, of which more than $31 billion (60 percent) was earned from off-farm sources. In fact, the <u>net</u> income from farming needed to exceed $40,000 before the percentage of farm income exceeded that from off-farm sources (76).

The importance of this observation is twofold. First, the amount of total family income is more important than farm income in determining the quality of life level. Second, the question of whether and/or how much of the off-farm income is reinvested in the farming enterprise becomes an important consideration when analyzing changes in the farm sector.

In summary, data for analyzing the impact of foreign investments on land use, agricultural production, and farm income are extremely limited and fragmented. However, the data that are available do not support the often-expressed conclusion that foreign investors decrease the intensity of land use, which will result in lower agricultural output and income.

INTRODUCTION: IMPACT ON RURAL COMMUNITIES

As indicated in the earlier introduction, the impact of foreign investments in farmland are examined from two viewpoints: (1) within the farm sector; and (2) between the farm sector and the rural community. The emphasis in this section is on the relationships between foreign investments in farmland and the performance of the economy in the local communities where the investments are made.

The methodology for estimating the impacts of various phenomena on the economies of rural communities is well-established. A large number of so-called impact studies have been conducted. These studies have focused on a wide variety of phenomena, including recreation development, extractive mining industries, and the location of new manufacturing firms.

A characteristic of many of these studies is that they have involved rather significant research efforts devoted to documenting or projecting the structural changes in agriculture. For example, a study designed to estimate the local economic impacts of the Bureau of Reclamation's Colorado-Big Thompson Project (32) was preceded by a comprehensive study of the structural changes occurring in the agricultural sector of the region serviced by this irrigation project (2). A more recent impact study focused on the local economic impacts of the falling water table in the Great Plains area (25). Here again, detailed studies concerning hydrological changes and the related agricultural adjustments preceded the impact study (51).

The point of these studies is that before one can empirically estimate the impacts of a given phenomenon on the economies of rural communities, it is necessary to determine the impacts of the phenomenon on the structure of agriculture. As has been developed in the previous sections of this paper, it is clear that basic information concerning the relationship between the phenomenon of foreign investments in farmland and the structure of agriculture is very limited. The magnitude of the foreign investment is not well-documented, and even less is known about the structural changes in agriculture that are associated with this investment. Thus, the discussion of the local economic impact of foreign investments is, of necessity, largely conceptual.

The organizational approach used in this section is to start with a discussion of a conceptual framework and the associated empirical models for analyzing the impact of foreign investment on rural communities. Within this framework and given the hypothesized affects of foreign investment on the structure of agriculture, four of the major avenues by which local communities may be impacted are analyzed empirically and conceptually.

The combination of a conceptual model, supported by information from published impact studies and integrated with the limited information available on foreign investment in farmland, should provide the following:

1. Tentative hypotheses concerning the more important ways in which foreign investments may affect rural communities; and

2. Identification of key information gaps that must be filled before accurate estimates of local economic impacts can be made.

CONCEPTUAL MODELS OF RURAL ECONOMIC SYSTEMS

Most empirical impact models are based on two bodies of theory. The first is commonly referred to as export-based theory. As Edwards (23) points out, this theory is largely demand-oriented. This theory suggests that the level of economic activity in a community is determined largely by the extent to which that community can export goods and services. However, it does not address the question of what determines the level of exports, nor does it address the relationship between the local economic structure and levels of export demand.

Central-place theory picks up where export-based theory leaves off (16). That is, central-place theory addresses the specific question of, when given the level and spatial distribution of export activity in a region, what type of service centers will develop to service the individuals and enterprises engaged in export activities? In the simplest terms, central-place theory assumes that a hierarchical system of service centers (rural communities in the case of agriculture) will develop to service the export-based activities. The types of communities within this hierarchy will be differentiated on a basis of the range of goods and services (complexity of the community) that are offered in the rural communities.

The complexity of the rural community basically is determined by: (1) the demand for a given service by individuals in the area; and (2) the economies of size associated with providing that service. For example, if a particular good is demanded in relatively large quantities by all of the export activities and/or if the good can be produced economically on a relatively small scale, then that good will be available in the small communities.

In terms of communities whose primary objective is to service the agricultural sector, one would expect that the farmer's demand for minor repairs to be a weekly if not daily occurrence. In addition, the capital requirements for minor repair shops are relatively low. Thus, one would expect even small rural communities to have repair and parts businesses. Conversely, farm equipment dealers often have substantial overhead and must sell a relatively large number of units to cover fixed costs. Thus, major equipment dealers tend to be located only in medium or larger sized rural communities.

Central-place theory is based on the argument that the level of activity and the complexity of rural communities is directly dependent upon the

expenditures of agricultural firms (the farm enterprise) and the personal expenditures of farm owners and employees. Within this theoretical model, the extent to which changes in the agricultural sector will affect the local economy depends upon three factors.

The first and most obvious factor is the volume of goods and services being exported out of the community. If a significant amount of the area's agricultural land is idle and relatively little is being produced for export, the level of input purchases by the agricultural sector as well as the consumption expenditures of the farm families are likely to be relatively low.

The second factor is the extent to which the inputs required by farmers are purchased in the rural community versus from firms outside the community. Of prime importance here is the labor employed by the exporting firms. The reason this factor is important is because labor is typically a local input (ignoring some in-commuting), and typically a large part of the personal expenditures by these farm laborers are made in the local community. Although the production-type worker in an export firm typically may be a local resident, the managerial labor may not reside in the local community. Professional farm-management services of a major corporation are a case in point. Often, higher management decisions are made by individuals who are stationed at the corporation's headquarters, and as a result, less of the managerial income impacts on the local economic system.

Nonlabor inputs also are important in determining the impact of an export industry on the local economy. There are significant variations among exporting sectors in the amount of nonlabor inputs purchased locally. Even within the agricultural sector, this variation may be significant. What is important from the perspective of the local economic systems is the magnitude of output from the export industry and the degree to which these industries purchase inputs in the local community.

A third factor that determines the impact of export activity on a local community is the complexity of the economic structure of the local community. In general, the complexity of the economic structure of a community relates not only to the supply of inputs which the exporting activity can purchase locally, but more importantly relates to the degree to which income and employment are generated as a result of purchases by the exporting sector. As a general rule, in a complex economy a $1 purchase by an exporting sector will work its way through numerous sectors before "leaking" from the local community. Significant amounts of additional income and employment will be generated in these sectors. On the other hand, in communities with relatively simple structures, the dollar spent by the exporting sector will "leak" from the community rather rapidly, and as a result will generate relatively little additional income and employment.

In summary, export-base and central-place theory hold that the impact of an export activity on the local community depends upon the magnitude of the export activity, on the spatial purchasing patterns for the inputs used

by the export activity, and on the complexity of the local economic system. Before applying these conceptual models to the foreign investment issue, it is useful to first briefly survey the models that have been used to give these theories empirical content.

ANALYTICAL MODELS FOR MEASURING COMMUNITY IMPACT

The two classes of models which have been used to "operationalize" this body of theory and to provide empirical estimates of community impacts are: (1) export-base models; and (2) input-output analysis.

At this point, the logical question is which of these two models is the most appropriate for analyzing the impact on rural communities of foreign investment in agricultural lands? This decision is important in two regards. First, it provides a logical structure from which hypotheses concerning various types of local economic impacts can be formulated. Second, it explicitly focuses on the information requirements necessary to empirically estimate these impacts.

In general, export-base models are not the appropriate impact model for analyzing foreign investments. The export-base model uses employment as the unit of measurement, with the implicit assumption that one employee engaged in export activity is representative of all employees in export activity. The model also is based on the assumption that nonlabor input purchases are proportional to export employment across the various export sectors. However, in the case of foreign investment, the limited information available and popular conceptions are that neither of these assumptions is likely to be true. For example, one of the suggested impacts of foreign investment is that the labor involved in the export activity (agriculture) will become quite different because the foreign-owned farms will employ only farm labor and the managerial labor will be from outside the community (59). Also, one of the major concerns about foreign-owned farms is that their input purchases of nonlabor items will be quite different from those of the domestic farmers (60). Specifically, it is suggested that they may use a different resource mix than the domestic farmer and will have different spatial purchasing patterns for the inputs. Thus, it appears that the input-output framework is the appropriate model to use.

A variety of input-output models have been used, depending upon the nature of the phenomenon under investigation and the structure of local economic systems. Perhaps the most commonly used model is the "ordinary" input-output model, as outlined in Miernyk (52). Basically, this model treats the local economy as an open economy in which exports have a major role. The relevant characteristics of this type of model are the assumptions that: (1) all sectors in the local economy produce with constant returns to scale and (2) all factors of production exhibit perfect elasticity of supply. That is, the models assume that the phenomenon under investigation will not change the demand for inputs enough to affect the price of those inputs. Thus, no resource constraints are built into this model. In

addition, it is assumed that both input and output prices remain unchanged. Finally, and perhaps most importantly since this assumption is likely to be violated frequently, it is assumed that the structure of the local economy does not change. More specifically, this suggests that the phenomenon under consideration must be small relative to the local economy so that no additional lines of business will become economically feasible.

A second type of input-output model that is used occasionally is referred to as an input-output/linear-programming model (4). Basically, these models explicitly recognize the fact that certain community impacts may imply the use of additional resources that are not available either in a physical or in an economic sense. Thus, the magnitude of community impacts may be limited by the constraint on particular resources, such as land, labor, or other inputs which are effectively constrained by spatial considerations.

A third class of input-output model that has been used only sparingly, primarily because of the voluminous data requirements, is an input-output/quadratic-programming model (28). In general, this formulation recognizes that some of the impacts under investigation may alter relative prices. This formulation involves elasticity of demand estimates so that relative prices are allowed to change as the impact works its way through the economic system.

A fourth type of input-output model is dynamic in nature (38, 71). The distinguishing feature of this class of model is the recognition that the structure of economic systems may change as a result of changes in export demand. In this class of model, endogenous investment sectors are incorporated which generate investment in existing and new sectors of the local economy. Alternatively, the structural change of the local economy is depicted as exogenous. For example, if the impact of an irrigation project is under consideration, it is explicitly recognized that the conversion from dryland to irrigated farming will require additional sectors in the economy of local communities. Specifically, sectors supplying irrigation sales and service will be required. Thus, the structure of these sectors is introduced into the input-output models, even though they did not exist in the base period and no endogenous investment sector is used.

This brief discussion indicates there are a variety of input-output models available. The question is: Given our limited information about foreign investment, which of these models appears to be most appropriate? The input-output/linear-programming model probably is not the reasonable choice. The popular conception is that foreign investment in farmland will tend to contract the economic activity in a local community and, thus, no additional constraints on resources are going to come into play (3). Even if the popular conception is wrong and foreign investments have an expansionary effect on local economies, the magnitude of current foreign investment is such that constraints on the communities' resources base probably will not be significant.

It is for basically these same reasons that an input-output/quadratic programming-model is not appropriate. That is, the impacts of foreign investment on any local economic system are not likely to significantly change relative prices since the prices of most of the inputs under consideration are established in national markets. Thus, what happens in an individual community is not likely to significantly affect factor or product prices.

Likewise, it appears that the "ordinary" input-output model may not be appropriate. There is some reason to expect that one of the dominant impacts of foreign investments is to increase the amount of investment capital available in the local community, which, in turn, may substantially alter the structure of the local economic system. That is, foreign investments in agricultural land may increase the investment capital available in the rural community and thus provide the funds for local entrepreneurs to start new lines of business--which represents a change in the structure of the local economy.

It appears that some type of dynamic input-output model is required to analyze foreign investment in farmland. In the following section, we discuss the basic nature of this model within the context of the limited information concerning the impacts of foreign investment on the structure of agriculture and present limited information dealing with the role of increased capital availability on the structure of local economic systems. This information, combined with existing input-output studies, should indicate the potential impacts of foreign investment. The input-output studies discussed are not dynamic, but they are the best information available on community impacts and do indicate the relative importance of agriculture on local economic activity.

MEASUREMENT ISSUES ASSOCIATED WITH ESTIMATING COMMUNITY IMPACTS

Intensity of Use

Both conceptually and in the context of the input-output models, the volume of goods and services exported from a rural area is a dominant factor in determining the general level of economic activity in rural communities. In many rural communities and particularly those that are of concern in this study, agricultural products are a major portion of the exports from the rural area.

Potentially, foreign investment in agricultural land may significantly alter the volume of agricultural commodities being exported from a rural area (3). That is, it is suggested that foreign owners may not significantly change the land-use patterns on a farm but may farm the land less intensively than would a domestic owner. As a consequence, if the land is farmed less intensively, production will decrease and the export of agricultural commodities also will decrease.

There are several conceptual arguments for hypothesizing this relationship between foreign ownership and intensity of land use. Dovring (19) argues that there may be a conflict between the objectives of maximizing net rental income and the objective of maximizing value of production. He argues that the foreign owner may stress the former of these objectives and thereby reduce the level of production. Additionally, Gaffney (29, 30) argues that foreign owners may have security reasons as their primary motive for purchasing agricultural land and as a result does not operate the farms in a profit-maximizing manner. Although the conceptual arguments supporting this hypothesis are relatively strong, there is little evidence to empirically test this hypothesis. For example, Gaffney quoted extensively a study conducted in 1900 (73) which testifies to the lack of more recent empirical work in this area.

More recent evidence, based on very limited data, indicates that this hypothesized relationship may be questioned. In a survey conducted for this study, data were collected in 24 counties where one or more foreign owners had purchased agricultural land. In this survey, only one of these 24 counties contained farms under foreign ownership that were being farmed less intensively than they had been under domestic ownership. Perhaps more importantly from the perspective of the local communities, the intensity of the crop production was reported to have increased in 8 of the 24 counties and 15 counties reporting no change in intensity of use. Thus, it is apparent that the hypothesized negative relationship between foreign ownership and intensity of agriculture is still in question.

The following discussion demonstrates the critical need to document the relationship between foreign ownership and intensity of agricultural use as a prerequisite to establishing a relationship between foreign investment and changes in economic activity in rural communities. The importance of agricultural exports to local economies (as measured by total multipliers) varies widely.[41/] For example, in a Colorado study (32) which included 18 separate agricultural enterprises, the total multipliers varied from approximately 2.1 for the feeder cattle and sheep sectors to 3.7 for the range cattle sector. On the average, the multipliers in this

[41/] In this discussion, input-output multipliers are used to indicate the importance of exports of a particular sector on the rest of the local economy. Two types of multipliers frequently are reported. When an export activity increases, additional inputs are purchased from local businesses. Output multipliers indicate how much total business in the community will increase in response to a $1 increase in exports. The increased business activity will result in increased payrolls or income. Income multipliers indicate how much income in the community will increase in response to the increase in business activity. The term "total multiplier" denotes the sum of the output and income multipliers and reflects the increase in both output and income that is associated with a $1 increase in exports.

study averaged slightly more than three. In a study by Lund (47) in four counties in southwestern Wyoming, all agricultural activities were combined (i.e., aggregated into a single sector). He estimated that the output multiplier for this sector was 2.33--that is, increased output in local businesses of $2.33 per dollar of exported agricultural products, with an additional 91 cents in income and local tax receipts being generated. Thus, he estimated that $1 worth of exports from the agricultural sector in the region would increase total business and income in the region by $3.24.

In two studies reported on by Maki (50), multipliers were calculated for a crops sector and/or for a livestock sector. One of these studies involved a single county in Minnesota, and the second study was of a seven-county area in North Dakota. The total multiplier for the agricultural crops sector in the Minnesota county was 2.77, and for the seven-county area in North Dakota the crop's multiplier was 3.02. The total multiplier for livestock in the North Dakota area was 3.27 (the livestock sector did not exist in the Minnesota county). Similarly, in a study of a two-county area on the eastern shore of Virginia which utilized only one agricultural sector, the estimated total multiplier was estimated to be 2.79.

A similar study of a county in Delaware reported total multipliers for the agricultural sectors ranging from 1.6 for the broiler industry to 2.77 for livestock farms (11). In this study the field crops sector, the fruit and vegetable sector, the livestock farm sector, and the fish, forestry, and mining sectors all had total multipliers equal to or greater than 2.5. The poultry, meat, and dairy sector, along with the broiler industry, had total multipliers of 1.8 and 1.6, respectively. In a similar study of one Oklahoma county, it was estimated that each $1 of farm sales generated $1.78 of business in the county (39).

An attempt has been made here to provide a representative sample of input-output studies of small areas with relatively simple economic systems. These studies are likely to be representative of the economic systems in many small rural communities where the community's primary function is to service the agricultural sectors. A reasonable estimate of the magnitude of the total multipliers for agriculture in general is somewhere in the range of 2.5 to 3.0. That is, for every $1 worth of agricultural products exported from a rural area, the sum of increase in business and income is $2.50 to $3.00. These multipliers are quite large, considering the size of the areas involved in these studies and in comparison with the multipliers from other sectors in the same studies.

In most of the input-output studies discussed above, manufacturing sectors were included, and without exception, the agricultural multipliers were larger (often by a factor of 2) than the manufacturing multipliers. In the Delaware study, the total multiplier for the apparel and textile industry was 1.36, compared with the agricultural multipliers reported above. In the Minnesota and North Dakota studies, the total multiplier for

the "other manufacturing and mining sector" was 1.71, compared with the lowest agricultural multiplier, which was 2.77. In the Virginia study, the total multiplier for agriculture was 2.79, compared with 1.99 for manufacturing.

The comparison of the multipliers for agriculture and manufacturing in the Wyoming study also point out a rather important role for agriculture. That is, Lund used two manufacturing sectors in his study. One for lumber and one sector including all manufacturing activity except for lumber products. The sector for all manufacturing activity other than lumber had a total multiplier of 3.03, compared with a total multiplier for the agricultural sector of 3.24. A closer examination of the manufacturing sector in this study reveals that this sector is primarily agricultural processing. For example, approximately 40 percent of the inputs purchased by this sector come from the agricultural sector. It would seem that agricultural processing industries tend to have large multipliers. This result was confirmed in Maki's study where the food processing sector had a total multiplier of 2.8, compared with 1.71 for other manufacturing activities. In summary, then, it is clear that most local economies are very sensitive to changes in the export of raw or processed agricultural commodities.

Another dimension of the intensity issue that may be important to the local economy is that the foreign owner may alter the enterprise combinations used on farms. That is, the question addressed above is whether foreign owners engage in a given agricultural production activity as intensively as domestic farmers. Another issue is whether they convert to agricultural enterprises that are less labor-intensive than the ones typically used by domestic farmers.

There is some evidence in the survey of the 24 counties in which foreign investors had purchased land that there may have been some changes in the enterprise combination, which implies less-labor-intensive activities. For example, 5 of the 24 counties reported foreign-owned farms had abandoned livestock enterprises in favor of purely cropping enterprises. One farm reported that row crops had been abandoned in favor of timber production. At least with respect to labor, these conversions are likely to be a less-intensive use.

Some indication of the impact of these enterprise changes on the rural community is provided by examining the total multipliers for the various enterprises. In the Colorado study, the multipliers for the range cattle and fat sheep sectors were 3.7 and 3.6, respectively, compared with 2.7 for the corn-cropping sector. In the North Dakota study, the total multipliers for the livestock and cropping sectors were 4.16 and 3.56, respectively. In the Virginia study, the total multipliers for the livestock and poultry sectors were both 2.46, compared with 1.67 for the field crop sector. Although the impact of changing enterprises on the rural community depends on the levels of output in the respective enterprises as well as on the multipliers, it is clear that the enterprise changes observed in the

24 counties have the potential to reduce the level of economic activity in rural communities. Thus, these two important dimensions of intensity of use must be carefully documented, namely the intensity with which foreign farmers carry out a given activity; and secondly, the propensity of foreign farmers to convert to less-labor-intensive agricultural enterprises.

Nonlocal Marketing

In addition to the intensity issue, there is a concern that foreign owners will not market their products locally and that this will adversely affect rural communities. Rogers and Barkley (3) suggest that, in specific instances, the foreign owner may ship the agricultural products from his farm directly out of the community and perhaps even out of the country. In essence, this is what Irland (37) reports the Japanese have been doing with respect to lumber products. That is, instead of exporting plywood to the Japanese, we have been exporting raw or semiprocessed timber products. To the extent this phenomenon is associated with foreign ownership, it would tend to have a negative impact on local communities. However, one must realize that, from a community perspective, such a phenomenon simply implies that the export of unprocessed agricultural products has increased. Thus, the impact on the community will be the net difference in these two rather than the gross impact of decreased exports of processed agricultural products. The other thing to remember is, in many instances, it probably would be possible for the agricultural processing firm to import additional raw products to replace those that the foreign owner exported directly. This is more likely to be the case for nonspecialty crops and for crops that have relatively low transportation costs. Thus, the net impact on the community is likely to be negligible because new imports are balanced by new exports. Although such marketing practices by foreign owners are likely to affect relatively few rural communities, it would be desirable to have information on the spatial marketing patterns used by foreign owners, compared with the patterns for domestic owners.

Spatial Purchasing Patterns

The preceding discussion concerning the intensity of produciton on foreign-owned farms is important simply because it has direct implications concerning the quantity of inputs that will be purchased by foreign farmers, as contrasted to domestic owners. From the point of view of the rural community, an equally important question is where do the foreign owners purchase their labor and nonlabor inputs. Regarding purchases of nonlabor inputs, Atkinson and Jones (1) have noted the concern that "local businesses may be bypassed" by foreign farmers. Also, Schmedemann (60) argues that foreign investment in agricultural land will result in a "large decrease" in the economic growth and level of employment in rural communities. The reason for this is primarily the spatial purchasing patterns of nonlabor inputs by foreign farmers. They will, he argues, purchase their inputs "from large regional service centers and in some cases directly from the manufacturers." (60, p. 18).

The importance of the spatial purchasing patterns of nonlabor inputs can be illustrated by the comparison of multipliers for certain manufacturing activities, compared with those for certain agricultural enterprises. As was discussed above, certain manufacturing activities have much smaller multipliers than do most agricultural activities. This is somewhat surprising in the sense that textile manufacturing, for example, is a labor-intensive operation and textile plants in rural communities traditionally employ predominantly local labor. Thus, one might anticipate relatively large impacts from this type of activity. However, input-output studies indicate that this is not the case, and the explanation for it can be found largely in the spatial purchasing patterns for nonlabor inputs. The typical textile plant in a rural community purchases the labor in the community but relatively little else. Although they may rent a building and make other minor purchases in the community, the major inputs such as fabrics and sewing machines typically are purchased outside of the community; thus, they have relatively small multipliers.

Despite often-expressed concerns regarding the spatial purchasing patterns of foreign owners, there is essentially no information that explicitly addresses this issue. However, based on limited information, an argument can be made for the hypothesis that the spatial purchasing patterns for foreign farmers will not be significantly different from those of domestic farmers. The argument is that most foreign purchasers of agricultural land are not interested in becoming bona fide farmers, i.e., that they will not participate in day-to-day management decisions. Most foreign owners apparently are looking for inflation hedges and politically secure stores of wealth. Additionally, the information presented above suggests that many foreign owners rent their land to local farmers who own other land. If these two conjectures are true, it would follow that the local farmer makes the input-purchasing decisions, and it is likely that the spatial purchasing patterns on the foreign-owned farm would be similar to those of the local farmer.

It is apparent that there are opposing views concerning the effect of foreign ownership on the spatial purchasing pattern of nonlabor inputs. However, it is generally agreed that the economic health of rural communities is very sensitive to the spatial purchasing patterns; thus, it is important to document any differences in the spatial purchasing patterns of foreign and domestic owners.

The spatial purchasing pattern of labor inputs is perhaps even more important to the rural community than the pattern for nonlabor inputs. It appears that agricultural purchases of labor inputs generate more income and employment in the rural community than do nonlabor inputs. The reason for this is that income generated by labor purchases does not "leak" from the local economy as quickly as income generated by nonlabor purchases. For example, when a farmer purchases labor, the worker is likely to make most of his personal consumption expenditures in the local community, and this creates additional income and employment. On the other hand, if a farmer purchases a tractor, the farm equipment dealer purchases a majority of his inputs outside the community; thus, much of this

nonlabor expenditure "leaks" from the community almost immediately. A second reason why the spatial purchasing pattern of labor resources is important is that potentially the transfer of a farm from a domestic to a foreign investor may affect the spatial hiring patterns for labor inputs more than for nonlabor inputs. To focus on this issue, it is useful to analyze the role of net farm income in a community.

In general, net farm income can be viewed as being comprised of three components. One component is the opportunity cost of nonhired farm labor. Typically, this is the labor supplied by the farm operator and his family. A second component is the management inputs typically supplied by the farm operator. The third component is the economic rent accruing to the farmland and machinery.

The spatial purchasing patterns of farm labor (both hired farm labor and farm family labor) are not likely to change radically with the transfer of the farm from a domestic to a foreign owner. That is, assuming there is not a significant change in the intensity of agricultural production, the same amount of farm labor will be required, and only in special circumstances would one expect much of the farm labor to reside outside of the rural community. On the other hand, there may be significant transfers of the other components of net farm income from the community when land is transferred to a foreign owner.

In the case of the domestic farmer, net farm income represents a sum of money available to the farm family which makes decisions concerning how that income is to be used. In general, it could be expected that the majority of this money would work itself into the local economic system in one way or another. For example, the farm family probably will utilize part of the net income for personal consumption items (both durable and nondurable), and a majority of these purchases will be made in the local community. The remainder of net farm income likely will be invested in one form or another. Potentially, a part of this balance will be invested in the farm in terms of capital expenditure to improve the productivity of the farm. Again, one would presume that a majority of these expenditures will be made in the local community which is designed to service the agricultural sector. Part of the net farm income may be saved by the farm family, in which case it is likely to enter the financial sector of the local economy in the form of savings accounts in commercial banks or savings and loan associations. Thus, it is through these expenditure patterns that one would anticipate that the majority of net farm income would be directed through the local economic system.

The spatial purchasing patterns of the foreign investor which arise from the returns to management and economic rent accruing to land and machinery may be quite different. For example, the foreign owner may employ a large commercial farm management company to manage the farm. In many instances, these farm management companies will not be located in the rural community, and thus the return to management from the farm will bypass the local economic system.

The economic rent accruing to land is perhaps even more important, both because of its magnitude and because it has a high potential for bypassing the local economic system. In the case of a foreign investor, the return to land and machinery by definition leaves the local economic system, at least in the first instance. The foreign investor may make a conscious decision to return part or all of this economic rent to the farm in terms of investments. However, the proportion of economic rent that is not reinvested in the farm by the foreign owner is not likely to enter the financial sector of the local economy in the form of savings. Those engaging in foreign investment in agricultural lands have a much broader range of investment opportunities than does the domestic farmer. Again, the potential importance of this issue is illustrated by the relatively small input-output multipliers for manufacturing plants in rural communities. Many of the managerial decisions are made by employees who reside outside the community. Likewise, the profits from the absentee-owned plants accrue to individuals residing outside the community. Thus, the returns to capital and management traditionally do not enter the local economic system. As has been argued above, the farm family and the farm firm typically make most of their purchases in the community. Thus, the difference in the multipliers for agricultural sectors and for certain manufacturing sectors is explained partially by the spatial purchasing pattern of these inputs. Clearly, if the foreign investor substantially alters the purchasing patterns, the local economic system will be adversely affected.

The question is how do foreign investors use the economic rent? Although this question has not been addressed explicitly, some insights can be gained from related studies. There seems to be some agreement that foreign purchasers of agricultural land tend to have higher equity positions than do domestic purchasers. On the conceptual level, it is argued that foreign investors may have different motives for buying agricultural land than do domestic farmers and, as a result, one could expect different equity positions. For example, Breimyer (9) argues that one of the prime motives of foreign investors is to find a nondepreciating asset to purchase with the large number of dollars in foreign hands resulting from oil imports. Investors with these motives are likely to have high equity positions in the investments they select. Brannon (8) argues that another motive of foreign investors is to find a politically safe store for their wealth. Again, one would expect investors with these motives to have relatively high equity positions. In addition, Burke (15) argues that the banking institutions in this country require substantially more information from borrowers than is customary in many foreign countries. This fact combined with the desire on the part of some foreign investors to remain anonymous tends to result in more foreign than domestic investors making "cash purchases."

Although there is little empirical information concerning this issue, a survey of seven firms active in foreign investment in farmland indicated that foreign purchasers do in fact prefer high equity positions. The seven firms interviewed indicated that at least 50 percent of the foreign

purchasers used no funds from the United States. One of these seven indicated that all of the recent transactions with which their firm had been associated were totally financed with foreign funds. Thus, it is fair to assume that most foreign buyers have high equity positions relative to domestic buyers.

The implication of this finding in terms of the local communities is that much of the economic rent from farms owned by a domestic purchaser may be used for debt service. On the other hand, the foreign investor with a high equity position may have to use little, if any, of the economic rent for debt service. Thus, the foreign investor is likely to have more discretionary funds than the domestic purchaser. This may explain the reason that the survey of 24 counties indicated that in 12 of the 24 counties foreign investors had improved the farm in one way or another. Only one county reported that the foreign owner was letting the farm deteriorate, and 9 counties reported that there was no change. If this pattern is typical, it may very well be that foreign owners provide economic stimulus to the economies of rural communities. However, before one can reach this conclusion, it will be necessary to document that this pattern does hold in general and that a majority of the purchases used to improve the farms are made in the local community.

In general, it appears that the spatial purchasing pattern of the operational inputs (both labor and nonlabor) and the level of and spatial purchasing patterns of capital improvements used in agriculture affect the economic health of rural communities. It is equally clear that the affect of foreign investment in agriculture on these patterns is not well documtned. Fragmentary data and conceptual analysis would suggest that foreign investment may increase the level of capital investment on farms and may not seriously affect purchasing patterns. However, before one can have much confidence in this conclusion, significant amounts of additional information are required.

Complexity of Economic Structures

Above, it was argued that conceptually the impact of agricultural exports on rural communities depends to some extent upon the complexity of the economic system in rural communities. Potentially, the major impact of foreign investment on rural communities is the impact it has on the complexity of economic structure of rural areas. Since this topic has received almost no attention, this section attempts to develop a scenario of this potential relationship to highlight the areas requiring research and the possible importance of this effect.

Gaffney (30) argued that sales of assets among citizens of a country do not create additional investment capital. One side of the sale creates investment capital, but the purchase side of the transaction absorbs investment capital--so there is no net addition from this type of sale. Even though these sales do not create investment capital, they may transfer investment capital from one region of the country to another. For

example, Schmedemann (60) argues that motives for purchasers of land can be categorized into one of three classes: production, consumption, and inflation. In addition, he argues that most purchasers who are trying to hedge against inflation are absentee owners. The purchase of a farm from a local resident by an inflation-hedging buyer may transfer investment capital into the local community, even though no additional investment capital is created from a national perspective.

On the other hand, Gaffney (30) argues that the inflow of foreign capital potentially creates new investment capital in the country, depending largely upon what the domestic seller does with the proceeds from the land sale. However, the regional implications of foreign investment are even more important from the perspective of the rural community. For example, a foreign investment in urban real estate may increase the amount of investment capital available in the United States. But this is unlikely to have any significant impact on capital availability in rural areas (see argument below). Conversely, foreign investments in agricultural land have a good chance of increasing the amount of investment capital available in the rural community. That is, there is a good chance the foreign capital used to purchase agricultural land will be deposited by the seller in financial institutions in the local community. If so, the investment capital available to both the agricultural and nonagricultural sectors of the local economy will have increased. This is in contrast to the situation in which the buyer and seller are both domestic citizens. For example, it would not be surprising to find the seller investing the proceeds from the sale in the same bank from which the buyer obtained the real estate loans.

Although there is very limited information on these types of capital flows, there is some indication that foreign investment may be increasing the amount of investment capital available in rural communities. In the survey of seven firms with significant dealings in the foreign investment market, the firms were asked to indicate what percentage of foreign purchases were financed by U.S. capital. Next, they were asked what proportion of the U.S. capital was obtained within the community and what proportion was obtained outside the community. Although there was considerable variation in the answer to the first question, the answers to the second question were near unanimous in agreeing that the only source of investment capital from the community was provided by the seller. This arrangement reportedly was nearly always at the request of the seller. In general, this limited information suggests that foreign buyers borrowed relatively less U.S. capital than domestic buyers, and--more importantly--foreign purchasers of agricultural land utilized very little capital from the financial institutions in the community.

As Gaffney (30) points out, the use of the proceeds from the sale by a domestic owner to a foreign owner determines whether the foreign purchase will generate new investment capital. In terms of foreign purchases of agricultural land, the essential question is what do the farmers who sell do with the proceeds from that sale? Relatively little work has addressed

this question, but a recent study of New York banks provides some hints (53). For example, the average demand deposit for retired farmers exceeded that of active farmers by a ratio of almost 2 to 1 ($12,021 vs. $6,079). In addition, this study reported that:

> It was mentioned in many case banks how retired farmers tend to stay around their local communities instead of heading south with all of their possessions, and consequently, they leave a considerable amount of funds on deposit with their local banks. Though the size of these deposits varied substantially in the case banks, they were a very important source of funds for most banks. (53, p. 116)

On the basis of this limited information, it would appear likely that the proceeds of sales to foreign investors would increase the amount of investment capital available through the financial institutions in rural communities.

The importance of creating new investment capital in rural communities is based on the assumption that there is a shortage of investment capital in rural communities. There seems to be general agreement that there is a shortage of investment capital, because, for one reason or another, the capital market is not effective in transferring investment capital over large geographical areas to the point where it will earn maximum returns.

Bryant (13) argues that regional variations in the availability of investment capital are a major factor in explaining regional variations in agricultural income. He states that the majority of investment capital generated in the United States is generated in the metropolitan areas. Since the capital market does not allocate this investment capital optimally over space, the farmers near these metropolitan centers have more access to the capital and are able to adopt new technology which increases productivity, while the farmer in remote areas is less able to make the same types of investment. Thus, farmers near metropolitan areas have relatively higher incomes than those in remote areas. The important point is that Bryant's major hypothesis is that the capital market does not function in an optimum manner.

Webber (82) has argued (in a slightly different context) that the reason the capital markets do not function optimally is due to uncertainty. Assuming Bryant's contention is correct that most of the investment capital is generated in metropolitan areas, Webber would argue that the reason capital does not filter out to remote areas is because the financial institutions in the metropolitan areas are not familiar with the investment potentials in remote areas. Therefore, there is a high degree of uncertainty associated with those investment opportunities and, as a result, the capital does not flow to the remote areas.

If there is a capital shortage in rural areas and if foreign investment in agricultural land increases the supply of investment capital in rural

communities, significant increases in the economic activity in the community can be anticipated. For example, domestic farmers may have investment potentials but are unable to obtain the funds necessary to finance these improvements. It also is possible that investment opportunities exist in the nonagricultural sectors of the rural economy. For example, a local entrepreneur may have believed there was adequate demand to start a new line of business in the community, but his attempts to obtain funds to start the business had been frustrated by the capital shortage. If the increased availability of investment capital makes it possible for this local entrepreneur to open a new line of business, the complexity of the economic structure of the community would be increased.

The impacts of additional investment in rural communities can be significant in terms of increased employment and income. For example, the increased investment on domestically owned farms probably would increase purchases from local businessmen supplying the inputs necessary for capital investment on farms. In addition, the increased investment on farms would tend to increase the long-run productivity and therefore the volume of agricultural exports from the community. As discussed previously, increased agricultural exports can provide a long-term positive impact on the local community.

The increased investment in the nonagricultural sectors may have an impact as significant as the increased investment in the agricultural sectors. If a new line of business can be supported by farmers in an area, then establishing it will decrease the import purchases farmers presently are making. Reducing the volume of imports used by the agricultural sector has a positive impact on the community which is essentially equivalent to increasing exports from the agricultural sector. Thus, foreign investment in agricultural land may significantly increase investment in both the agricultural and nonagricultural sectors, and this investment will almost certainly provide a stimulus to employment and income in the rural community.

Significant amounts of research are required before this potentially important impact of foreign investment can be estimated. As Maki (50) has argued, to estimate the impact of a particular phenomenon on a regional economy, one must have an input matrix for the economy both before and after the phenomenon has occurred. In essence then, one must predict structural changes in the local economy associated with the phenomenon as well as changes in the level of exports. Specifically, research needs to address two basic questions. First, does foreign investment in agricultural land increase the amount of investment capital available in rural communities? If the answer to that question is positive, the second line of research must focus on the question of what kinds of investment are these funds used to support?

Ongoing work in the general area of agricultural finance may provide some clues to the types of investment that would take place in the agricultural sector. However, relatively little research has been associated with the question of changes in community economic structure and the factors that

affect those changes. Although central-place theory would appear to provide a sound conceptual basis for investigating changes in community structure, very little analytical work has been conducted. For example, Berry (5), in reporting on a study in southwest Iowa, concludes that there is a systematic manner for community development in terms of the level and variety of services offered in rural communities. He states that there is "clear evidence for the independent existence of both a continuum and hierarchy" of rural communities and that the "levels of the hierarchy and corresponding groups of functions can be identified" for the communities in this study (5, p. 67).

In another report on the same study, Berry states that "such strong size regularities are evident that it is possible to construct a table in which the order of entry of central functions (lines of business) into central places is recorded" (6, p. 367). Basically, he argues that one can predict with a good deal of accuracy the next lines of business that will appear in a community if the community grows. Even though Berry found strong patterns in his data concerning the number of different lines of business in the rural communities, it is important to note that he argued that the communities in his study could be placed in one of three classes: cities, towns, and villages. For example, he argued that towns contained between 28 and 50 separate lines of business. In the context of estimating the impacts of agricultural exports on rural communities, there is a need for increased precision over that achieved by Berry. For example, even if one agrees with his classification, a "town" containing 28 lines of business will be affected quite differently than a "town" which contains 50 lines of business in terms of the income and employment generated by agricultural exports. In general, then, what is required is research addressing the issue of the factors associated with the level and variety of services provided (lines of business) in rural communities.

In a study by Brush (12) in southwestern Wisconsin, an explicit attempt was made to categorize communities serving agriculture in that region of the State. Again, the conclusion was that a classification scheme for communities could be developed, and the services associated with each of these classes could be identified. Unfortunately, Brush did not report on the reasons for the variety of services provided in a community other than its distance from other communities.

In a recent paper by Eberts (21), a method for identifying lines of business that may appear in a community are discussed. Basically, Eberts uses the Guttman scaling technique to categorize communities. He argues that if a community does not have a particular line of business the Guttman scale indicates it "should" have, then one can anticipate this line of business will be the next one to develop in the community. Although the work reported by Eberts involved only a few lines of businesses, the general approach is promising in terms of identifying lines of business that "should be in a community." The essential next step is to conduct research concerning the question of why the community does not have that line of business. Specifically, are shortages of investment capital a potential explanatory variable?

In summary, a significant amount of research is required concerning the relationship between the complexity of local economic structures and the availability of investment capital. If this relationship is a strong one, the foreign investment in agricultural land is likely to have significant positive impacts on employment and income in rural communities.

Local Government Fiscal Impacts

Accurate estimates of the impact of foreign investment on the fiscal operations of local governments must await more accurate information concerning the local economic impacts of foreign investment. However, given some limited information and the use of conceptual analysis, it is possible to identify some of the major fiscal impacts and speculate as to whether these impacts are likely to be positive or negative.

Most rural governments rely largely on the property tax as their source of revenue. To the extent that foreign investors increase the price for agricultural land, the property tax revenues received by local governments will increase, assuming no decrease in the tax rate. In addition, foreign investment in agricultural land may affect the tax revenues of local governments--depending upon whether foreign investors improve the farms they buy, which affects the value and therefore the tax revenues.

Foreign investment also can affect tax revenues of local governments by affecting the level of economic activity in rural communities. If foreign investments stimulate local economies, then presumably new businesses will be started and possibly new homes constructed. Both of these actions represent increases in the local tax base.

Some of the input-output studies discussed above attempt to estimate the impact of changes in local economic systems on local government revenues. The range of estimates on local government impacts testify to the difficulty associated with these types of estimates. The Virginia study, for example, estimates that each $1 of agricultural exports generates about 2.7 cents of local government revenues (62). On the other hand, the Wyoming study estimates that about 9.4 cents of local government revenues are generated per $1 of agricultural output (47). The difficulty with these estimates is that in many instances tax revenues are not closely related to economic activity in rural areas. Property taxes, for instance, do not fluctuate with economic activity to the same extent that sales and income taxes do; and since rural communities typically rely very heavily on property taxes, one must be very skeptical of the estimates obtained from input-output studies.

The impact of foreign investment on the demand for community services is likely to be relatively small. For example, school expenditures make up a large proportion of the total expenditures of most rural governments. Given the magnitudes of foreign investments documented above, it is not likely that foreign investment is going to change the demographic makeup of rural communities enough to significantly affect enrollments in rural schools.

Foreign investment may indirectly affect the demand for community services if foreign investment has a significant positive impact on the economic activity in the rural community. If this occurs, one would anticipate, as discussed above, the construction of new businesses and new homes. This construction might require additional water and sewer facilities in the community. In general, it is unlikely that significant changes in the demand for local services will result from foreign investment in agricultural land. Thus, foreign investment is likely to have modest beneficial effects on local governments.

RESEARCH AGENDA

The objective of this paper is to provide a framework for making judgments concerning the impact of foreign investment in United States farmland on agriculture and local communities on the basis of conceptual and limited empirical information. In this section, the research needed for improving these impact estimates is outlined.

The most basic research need is the development of benchmark data on the current level of foreign investment in farmland and the rate at which land is being transferred to foreign buyers. Data forthcoming from the new "foreign registration requirements" and the Census of Agriculture need to be analyzed to place the problem in perspective. However useful the information from these sources will be, it will not be sufficient because it is limited to a single measure of acreage being transferred to foreign ownership. The problem remaining is twofold. First, the aggregation of an acre of highly eroded, nutritionally exhausted land and an acre of highly productive prime land into a single measure of land is unacceptable for most types of economic analysis. The use of the more specific measure--such as acres of cropland--will be only a marginal improvement.

Of even more importance is the great difficulty in distinguishing between the "natural attributes" of land and the capital investments affixed to the land. For example, major irrigation projects in the southwestern United States did not increase the physical supply of land, i.e., increase the acreage of land, but most everyone would agree that the effective supply of farmland was increased. The point is that the supply of land is fixed and, therefore, a conclusion that sales to foreign buyers will decrease by a like amount the supply of land available to United States residents is only true if one employs the rather restrictive natural attributes definition of land. If policymakers decide on the need for an accurate record of present and future foreign landownership, it is important for the research decision to include a quality dimension and not just a listing of the acreage under foreign ownership.

A central issue is the need to better understand the changing structure of agriculture (size and number of farms), which, in turn, relates to the question of the "optimum" size of farm. If the optimum-size farm is larger than that typically available, market forces presumably will lead to: (1) farm consolidation; (2) an associated increase in size of farms;

(3) a decrease in the number of farms; and (4) an increase in the price of farmland. Although it is an oversimplification, two of the major determinants of the optimum size of farms are the economies of size issue and the nature of Government programs. For example, the continuing technological advances in agriculture may result in a need to increase the size of operation to reach the most efficient production point for the "typical" farm, and various Government programs may increase the profit-maximizing size of farm beyond that dictated by the economies of size issues. Additional research to determine the exact nature of the relationship between economies of size and Government programs will need to precede any serious study of the impact of foreign investment on farmland and rural communities.

A second important issue bearing on the structure of agriculture is the availability of credit to the agricultural sector. The inputs needed to operate the optimum size of farm probably will not be the same as those currently existing on the typical farm. Specifically, the farms may require additional land, capital, and conservation practices. A mechanism by which the optimum-size farm can be realized by an individual farmer is the borrowing of money to purchase the required inputs. Thus, one of the major research needs is to determine if there is a shortage of capital available to the agricultural sector which prevents the farmers from adjusting their operations to the optimum size.

The market forces associated with farmers attempting to adjust to a change in farm size implies changing levels of inputs. Of prime importance among these inputs is the land. Although substantial research is being done on questions of land values, specific studies are needed to determine if the increases in the price of land are primarily the result of the need for existing farmers to increase the size of their operations or whether the foreign investor has an important role. From the local government's perspective, an issue that needs to be examined is what happens to the level and distribution of tax revenues in areas where land prices are appreciating rapidly.

Other inputs included in the changing size of farms are very similar in nature to that of land. The issue of whether the proper level of expenditures--for conservation, labor, and production inputs such as seed and fertilizer is being used--depends, to some extent, upon the availability of credit in the community. A shift to larger farms would tend to require additional investments in conservation measures and increased expenditures for fertilizer and hybrid seeds. Conversely, technological advances traditionally have substituted capital for labor so that increasing farm size may imply less labor requirements in agriculture. Additional research is required to better understand the implication of changes in the optimum-size farm, the shifting of input requirements, and the role of credit availability.

The structure of agriculture is an extremely important determinant of the economic health of the local community. Changing input mixes in agriculture

can significantly affect the economic activity in a rural community, if the input mix is being shifted away from goods and services provided in the community. An equally important issue, from the point of view of the local community, is the spatial purchasing patterns of farmers. For example, if farm size increases, major increases in the purchase of fertilizers may take place. When purchases reach a certain level, it may be to the farmer's advantage to purchase inputs from regional distribution centers rather than from the local feed and fertilizer stores. Knowledge of the spatial purchasing patterns of farmers is thus a critical input in determining the level of economic activity in rural communities. Another determinant of the level of local economic activity is the availability of capital to nonagricultural businesses. Additional research is required to test the hypothesis that the economic viability of a community depends upon the demand for agricultural inputs as well as the capital availability to businesses which service that demand. Information on these issues is needed to determine what will happen to employment levels in the nonagricultural sectors, which, in turn, will directly affect employment and population changes in the rural communities.

The research studies discussed above are necessary to understand changes in the structure of agriculture and the level of economic activity in rural areas. More specific information is required before one can appraise the impact of foreign investment on the structure of agriculture and on the level of economic activity in rural communities.

An important issue related to foreign investment in land is the question of the impact of that investment on credit availability in the United States in general and in the rural communities in particular. Additional documentation is needed on the pattern of financing used in land purchases by foreign investors. Particularly important is the need to document the financial practices used by foreigners, compared with domestic purchasers. If foreigners rely less on United States sources for capital, the question is what do the domestic sellers do with the funds generated by the foreign purchases? Two major issues concerning the disposition of these funds need to be addressed. First, do the sellers use the proceeds to purchase consumption items or are the proceeds used in alternative investments? The second issue is whether the proceeds from farmland sales used for new investments are made in the local communities or in other regions of the country? Depending on the findings of this research, it will be possible to judge whether foreign investments increase the availability of credit in rural communities. Further, if it is documented that credit availability is a constraint on the agricultural and nonagricultural sectors of the rural economy, then foreign investment may have a positive impact on the level of economic activity in rural areas.

A determination of whether foreign investors have higher equity positions in their investments than domestic investors is important in judging the impact of foreign purchases on the operation of farms. If the foreign purchasers have more capital at their disposal to purchase their land, the result would be a net addition to the aggregate demand for land and a

corresponding impact on the price of land. Thus, additional research is needed concerning the elasticity of supply of agricultural land, and what the net addition to demand from foreign investors is likely to do to the price of land.

A related issue is the tenure arrangements on the land of the foreign investors, compared with the arrangements used on domestically owned land. The research design for addressing this is very important. For example, one approach is to investigate whether foreign investment generates a class of landless hired farm workers. However, the question also can be asked whether the foreign landowner increases the amount of land available for rent to: (1) existing farmers to permit them to increase the size of their operation; or (2) entering farmers who do not have the capital needed to purchase farmland.

In summary, the research emphasis should be on a comparison of the farming practices of foreign-owned farms and similar farms owned by domestic operators. From the point of view of the local community, the spatial purchasing patterns of foreigners, compared with domestic owners is of prime importance.

SUMMARY AND CONCLUSIONS

A major conclusion of this analysis is that the economic impact of foreign investment in U.S. farmland, from a national perspective, is currently very minimal. Although less than adequate data are available, the evidence available suggests that less than one percent of the U.S. farmland is owned by foreign interests and that less than one acre from each thousand acres of farmland is being transferred to foreign owners each year. Thus, except in isolated areas where foreign purchases are unusually high, the current impact of foreign investments in U.S. farmland on the agricultural sector and the rural community is relatively insignificant.

Some of the reasons for the public concern about foreign ownership seems to arise from: 1) substantial publicity given to specific foreign purchases; 2) general concerns about inflating land values and the declining number of farms which are perceived to be influenced by foreign purchases; 3) a view that the rate of foreign acquisitions will increase in the future; and 4) a fear of the unknown, i.e., how much farmland is owned by foreigners, what will they do with the land, and how it will affect farming and the rural community.

The recently enacted investment disclosure act and the forthcoming Census of Agriculture should provide "first estimates" of the current farmland holdings of foreign investors. However, questions of what this information means in terms of potential economic impacts on the agricultural sector and the rural community remain as elusive as before. Thus, the objective in this analysis was to examine the areas of probable economic impacts, and to the extent possible, support the analysis with empirical studies which serve as proxy measures of the potential impacts.

Some 13 areas of specific concern were examined for their potential in impacting on farming and the rural community. Specifically the relevant areas of interest examined were:

Agriculture Sector

1. Price of Land
2. Size of Farms
3. Credit Availability
4. Conservation and Improvement of Farms
5. Intensity of Use
6. Tenure Arrangements
7. Agricultural Production
8. Farm Income

Community Impacts

9. Intensity of Use
10. Non-local Marketing
11. Spatial Purchasing Patterns
    a) labor resources
    b) other inputs
12. Complexity of Local Community
13. Fiscal Impacts
    a) tax revenue
    b) public expenditures

For analytical purposes each of these areas of potential impact were evaluated separately, but with full recognition that a high level of interdependence exists between the specific areas. An attempt will be made here to combine the various areas in order to summarize the potential impacts from foreign investments in U.S. farm real estate.

The first two major areas of potential impacts relate to operation of the farm real estate market and to the basic organizational structure within the agricultural sector.

This analysis indicates that domestic forces--principally the desire to enlarge farm size--is the major factor pushing up the price of farmland. The impact of foreign investment on price is positive because it represents an added demand for a relatively fixed supply of land. It was argued that the present level of foreign purchases was not sufficient to have an important impact on price, but if foreign investment activity increases it could cause a substantial upward pressure on land prices.

A phenomena closely related to the increase in farmland prices is the potential for an increase in fiscal revenue to the community. A significant share of local tax revenue is from property taxes and increases in land prices, not offset by lower tax rates or assessment ratio, would result in increased tax revenues.

The arguments concerning the impact of foreign investment on farm size are very similar to those discussed for the price of farmland. Currently the level of foreign investment is too small to have a significant impact, but substantial increases in the level of foreign purchases may have important consequences. On the basis of limited data, it was concluded that foreign investors do indeed purchase larger size tracts--perhaps three times the norm--and thus decrease the total number of farms. However, this conclusion may tend to inflate the impact of foreign purchases because most of the tracts of land sold to domestic investors are for additions to current operating units. Thus, the raw data tends to exaggerate the size of the foreign purchases.

The point is that a direct comparison of the farm size of foreign and domestic owners should be between the total acre of the domestically owned farms (base unit plus incremental purchases for expansion) and the "whole farms" typically purchased by the foreign investor. Additionally, the limited evidence available does not support the contention that foreign owners engage in large scale farm consolidation. Thus, the foreign owners purchase large farms, but do not significantly decrease the number of farms.

The price-size questions concerning land are currently being subjected to more comprehensive analysis than any of the other potential impacts of foreign investments. The descriptive data published annually in USDA's Farm Real Estate Market Developments, supplemented by other ESCS, USDA reports, provides a relatively comprehensive picture of what is happening in the farm real estate market in terms of the price of land and size of farms. Additional research on why the price of land is inflating at such a rapid rate and more current economies of size studies for alternative farm enterprises would be very useful. Additionally, studies of this type would have a much broader application than answering questions about the impact of foreign investments in land. Studies of how local officials handle the level of revenue from property taxes in times of rapidly increasing land values would have important implications for the local community. Of special interest would be the redistributional impacts if farmland is increasing at a higher rate than other types of real estate, i.e., a potential for a shift of more of the tax burden to the farm sector would result if "across-the-board" reduction in either the tax rate or the assessment ratio were used.

The question of whether foreign investments in land will increase the credit available to the farm sector and the local community is a very complex issue discussed in some detail in the body of the paper. In general, information is needed on type of credit arrangements used by the foreign investor, who the previous owner of the farmland was and how the seller uses the receipts from the sale of the land. Conceptually, the probable impacts are fairly straightforward, but research is needed to empirically estimate the probable results of alternative investment scenarios.

Several of the other items examined in the study are closely related to the credit availability question (as well as the price and size concerns). One of the more important is the impact of foreign ownership in general and credit availability specifically, on the tenure arrangements within the agricultural sector. In general, it seems safe to assume that foreign ownership will increase the number of tenants and hired managers in rural areas if one assumes that some of the land is purchased from owner-operators. The disposition of the rent payments made to the foreign owner becomes a major source of potential economic impacts. As previously stated, the complexity of alternative scenarios makes it impossible to judge the magnitude of the difference in the probable impacts between the owner-operator and the tenant-foreign investor.

Three related items are substantially interrelated with credit availability as well as with the price-size issue. The first is the level of expenditures

for conservation and improvement of the farm real estate. In general, if capital is less limited for the foreign investor, the potential for higher levels of expenditures for these type activities would be expected--both from an opportunity cost of capital approach and the decrease in the percentage of income needed for debt servicing. The limited data available support the contention that foreign investors do tend to operate at a higher level of investment in conservation and improvement activities. However, significant additions to the research literature is needed before one can attempt to predict the relationship between foreign investments in farmland and the level of conservation and development expenditures on farmland.

Another issue closely associated with the question of conservation expenditures is the magnitude, if any, of the capitalized value of farm program benefits or public natural resource investment expenditures into the price of land. This would represent a direct benefit to the foreign owners at the general taxpayer's expense. Some of the complexities of this issue are addressed in the body of the paper, and it is an area which should receive high priority on a potential research agenda.

A second question is how do foreign investments affect local economic activity through changes in the spatial purchasing patterns for labor and non-labor inputs. There is little in the way of data that explicitly addresses the question of spatial purchasing patterns of non-labor input. However, since it appears that the majority of land under foreign ownership is farmed by local farmers who also own other farmland, one might not expect the spatial purchasing patterns for inputs used on the foreign investor's land to be significantly different from those used on the domestic farmer's land. This is a critical area for research because the magnitudes of money involved is quite large and potentially a great deal of variation exists between foreign and domestic farmers. That is, under foreign ownership, the economic returns to land may be diverted outside of the local economic system. On the other hand, the high equity positions of foreign owners may make possible substantial investments in the farm operation that is impossible for domestic purchasers because the latter must use the economic return to the land for debt service. The relatively high incidence of farm improvements reported for foreign investors might indicate that a majority of the net income from farm operations is being invested on the farm, and therefore is not diverted from the local economy.

A second major class of impacts from foreign investments relates to questions of the intensity of use of the farm and local communities' resources. The first of these concerns is the effect that foreign investment has upon the intensity of agricultural enterprises. The concern is that foreign investors will not farm the land as intensively as domestic owners primarily because they have various goals other than profit maximization in mind. The tentative evidence available would indicate that this has not been the case with foreign investors. In fact, the foreign owners may be farming the land more intensively than domestic farmers.

The specific issues of the impact of foreign investment on agricultural production and farm income will depend, to a large extent, on the findings of the research studies outlined above. At the present time the level of foreign investment is too small to have much impact on the aggregate level of production and income. However, if the foreign investment activity increases, and depending on the results of questions concerning size, availability of credit, and so forth, the long run implication could be important and should be subjected to scrutiny by the objective researcher.

The intensity of use of the land resources may also effect the level of economic activity through more readily available investment capital to support increases in the complexity of the local economic system and in capital expenditures by domestic farmers. The tentative evidence suggests that foreign investment in agricultural land does, in the first instance, create new investment capital in the rural communities (more sophisticated documentation of the financing used by foreign purchasers is required). On the other hand, almost nothing is known about how the sellers of land dispose of this new investment capital. Specifically, it is not known whether this new investment capital remains in the rural community or whether it is diverted out of the community. Also, there is almost no information on the relationship between the availability of investment capital and the complexity of economic structure of rural communities. Both of these topics require additional research before it is possible to reach any conclusions about the importance of this potentially important impact of foreign investment on the economic systems of rural communities.

In general terms, the impact of foreign investment on the fiscal expenditures of local governments cannot really be determined until the impact of foreign investments on the level of economic activity are determined. Tentatively, it was concluded that to the extent that foreign investment drives up agricultural land values, the revenues received by local governments will be increased as a result of this foreign investment. On the other hand, due to the large fixed investment associated with most local services it is unlikely that the cost of providing local services will change significantly as a result of foreign investment. However, this is merely a hypothesis and needs to be subjected to a rigorous research evaluation.

In conclusion, the emphasis in this analysis has been on the potential economic impacts of foreign investments in land. Other evaluations of the political, legal and social concerns were discussed very briefly, if at all. Any broad understanding of this public issue needs to consider these important considerations.

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Chapter 14

FOREIGN REAL ESTATE PRACTICES AND THE ECONOMY

Joseph F. Azrack and William L. Roberts*

INTRODUCTION

This report presents the findings and conclusions of a study conducted to determine the characteristics of foreign investment in U.S. real estate. The purpose of the study has been to provide background information for an analysis of the economic consequences of this type of investment for the United States. The economic impact analysis is the subject of a separate report.

For the purpose of this study, "real estate" has been defined to exclude agricultural land and owner-occupied residential units. The type of real estate investment studied includes commercial properties such as shopping centers, office and industrial buildings, hotels, and multiple-unit apartments as well as land development projects. A "foreign" investor has been defined as a nonresident alien, including domestic investment entities controlled by nonresident alien individuals or organizations.

Study constraints necessitated contacting a limited number of key informants knowledgeable and actively involved in foreign investment in U.S. real estate. In addition to John McMahan Associates' first-hand experience in dealing with foreign investment in U.S. real estate, information was obtained from 14 other highly qualified informants. These parties have been involved with the investment in U.S. real estate by foreign investors of more than $2 billion within the past 3 years. These informants are representative of major foreign and domestic investment and development organizations, investment advisors, financial institutions, real estate investment bankers, and law firms located throughout the United States. As a result, the information contained in this report reflects the experience and practices of relatively large and sophisticated investors who have the greatest dollar volume impact on the U.S. real estate market. However, the results of the study may not be representative of the reported large number of smaller foreign investors (investing less than $1 million). Where differences between the results of our research and John McMahan Associates' experience have been determined to exist, they have been noted in the report.

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GOALS AND OBJECTIVES OF FOREIGN INVESTORS

The expression "flight capital" was recurrent in the key informants' responses. The political and economic stability of the United States and its perceived position as "the last bastion of the free-enterprise system" was mentioned time and time again. Although other considerations such as appreciation potential, inflation hedge, and current yield also were named, it appears that the United States holds the position of safe harbor for investors in a troubled world. This view was expressed by individuals acquainted with investors from seemingly stable economies, such as Canada and Western Europe, as well as traditionally volatile nations in the Middle and Far East.

Some investors, particularly Far Eastern investors, use the United States to balance their investment portfolios' risks. That is, they choose low-yield, high-security real estate investments in the United States to offset the risk of high-yield, short-term "fliers" abroad. An example of the latter type of investment would be a speculative residential development project in Hong Kong, or elsewhere. Similarly, foreign investors tend to prefer long-term investment of capital in the United States, versus relatively short-term ventures abroad which are structured to turn over their capital in countries with greater economic and political volatility.

Except for a few cases, current yield, tax factors and "bargain hunting" seemed to play little part in the investors' strategies. Although not ignored, these considerations were viewed as sweeteners and not the basic substance of the United States attraction for foreign funds.

TYPES OF INVESTORS AND COUNTRIES OF ORIGIN

Our inquiries revealed investor types ranging from established U.S. development corporations with foreign parents, to overseas pension funds, to syndications being sold to upper-middle-class investors in Western Europe. The funds and syndications seem to indicate a trend toward increasingly "dispersed" foreign ownership, mirroring U.S. capital market aggregations of small investor interests. This is not to say that large individual, family, and "corporate" entities are declining, but that these traditional investors are being joined by the multitude.

The increasing popularity of U.S. real estate among "small" foreign investors stems from the weakened U.S. dollar bringing U.S. investment into the reach of European middle classes, the growth of these middle classes and, significantly, cheaper air travel which has made the United States a reality to many Europeans who visit and then return home with a first-hand experience, if not knowledge, of the U.S. market.

Countries of origin of foreign investment include most of Western Europe, the Middle East, Japan and the Far East, and Canada. Investor types vary among these areas, with financial institutions, pension funds, and syndications being dominant in Europe, and individuals and families in the Middle and Far East. Institutions from the Middle East also have been active real estate investors, principally on the east coast. Publicly

traded 1/ real estate investment and development corporations are by far the largest Canadian investors in terms of dollars invested, although a significant number of individual Canadian investors are active on a small scale in the border States, Florida and Hawaii. In terms of absolute dollar amount, Canadian investment probably dwarfs that of any other foreign source, even though it is virtually invisible to most Americans. (See Chapter 19.)

PREINVESTMENT ANALYSIS AND TAX CONSIDERATIONS

Depending upon the type of investor, all conventional analytical techniques seem to be used. "Discounted cash flow analysis" seems to be gaining popularity, apparently because it can be tuned to a given time horizon, and because professional investment advisors retained by some foreign investors are accustomed to working with this sophisticated analytical technique. This approach also is perceived by some to be important because of the depreciation provisions of U.S. tax law, which encourages selling or refinancing real estate investments every 5 or 7 years when cash mortgage loan amortization payments begin to exceed tax deductible noncash depreciation expense. Further, this method of investment analysis is necessary to forecast and evaluate the appreciation potential of investment opportunities in a market environment where current yield is perceived to be only a portion of the total return to be realized over time from the property.

Return on investment measures such as capitalization rate and "simple" return appear to be less relevant to the investors' goal of holding for the long term. When questioned specifically on U.S. real estate's return on investment, most informants indicated that the return on investment from U.S. real estate is slightly higher than that which is achievable from comparable properties abroad. However, this conclusion clearly varies with the country being compared. Whereas current yield from income-producing properties in Europe and the United Kingdom may be low, compared with the United States, returns in the Far East and Middle East are relatively high--although in these areas the returns are indicative of investment risk.

For the most part, foreign investors are no less sophisticated than their domestic counterparts. However, it is noteworthy that more sophisticated analytical techniques, such as discounted cash flow analysis, probably are more common to the institutional type of foreign investor utilizing professional investment staff or advisors than to the individual investor whose prinicpal resources are cash and an interest in acquiring U.S. real estate. For the latter type of investor, the investment decision often is based on the current return the property is represented to produce, the investor's satisfaction with the property's appearance, and only cursory analysis of potential future returns.

1/ These are corporations whose shares are owned by various private investors and traded on registered securities exchanges in Canada and, in some cases, the United States.

Tax considerations are secondary and seen as a bonus by most investors. This is not to say that great care is not taken to minimize tax liabilities through the use of offshore corporations and the like. However, almost uniformly, the informants stated that anything less than a major shift in U.S. tax law for real estate and/or foreign investment would not decrease the attractiveness of U.S. real estate.

TYPES OF INVESTMENTS

The most common types of real estate investments are shopping centers and office buildings in large urban areas and in the "Sun Belt" (e.g., Georgia, Florida, Texas, California, Arizona). This is consistent with the investors' desire to minimize risk, seek long-term goals, and not seek tax benefits as a primary objective (as in residential properties on which higher rates of depreciation may be claimed as tax deductible expenses). However, this conclusion must be modified in several respects.

First, German citizens investing individually and via syndications do seek to acquire real estate which, in addition to its other attributes, will minimize the investors' German tax liability. This is because German tax law permits operating expenses (including depreciation) associated with U.S. real estate investments to be deducted against income from the property, and losses, if any, may be deducted from the investors' taxable income in Germany.

Second, foreign investors have demonstrated a preference to invest initially in the region of the United States which is closest to home. For example, Canadians in the Northeastern and Northwestern States; Europeans in Eastern and Southeastern States; Mexicans in the Southwest and southern California; and investors from the Far East on the west coast.

In addition, the smaller investor's choice of type of property is limited by the amount of capital available. Consequently, although this type of foreign investor might prefer an office building or shopping center investment, available funds may limit the person to a less expensive property such as an apartment or light industrial building.

With the exception of foreign development companies (primarily Canadian) and a limited number of institutional investors who are active in development projects abroad and in the United States, most foreign investors have demonstrated a preference for purchasing existing income-producing property. This is because development projects are more risky, and require greater investor management participation than most foreign investors have the inclination or the capability to contribute. Further, development projects often involve properties (such as condominiums, residential subdivisions, or industrial parks) which will be sold to users or other investors upon completion. Since many foreign investors purchase U.S. real estate to hold for long-term investment, development-for-sale projects frequently are incompatible with their objectives.

FINANCING WITH U.S. LOANS

If debt financing is used, it originates almost exclusively in the United States. No evidence was discovered of third-party-debt financing from the country of origin of the equity investment. This appears to be due to the availability of U.S. debt, its nonrecourse nature, and low interest rates, compared with financing available in many other countries. It also may be due in part to foreign restrictions on overseas debt instruments held by State-regulated or -controlled institutions.

Some mention was made of "back-to-back" loans wherein foreign institutions lend in their currencies to U.S. banks or corporations overseas in exchange for those banks or corporations lending dollars in the United States. This arrangement composes only a very small part of the total debt financing situation, and is employed to avoid currency restrictions of some countries.

Leverage, or debt-to-equity ratios, are slightly lower for foreign investors than their U.S. counterparts. This appears to stem from a desire to increase current return in the prevailing market where equity returns are less than the cost of debt financing (negative leverage). Further, lower debt-to-equity ratios reduce the volatility of real estate investment's cash flow, in that fluctuations in revenue will have a lesser impact on cash flow after debt service.

Typical debt ratios ranged from 40 to 60 percent of investment cost, with a few lower or even zero. Exceptions were U.S. development corporations owned by foreign parents who operate with conventional high-leverage strategies like any U.S. real estate operating entity. Foreign pension funds are the most common purchasers of unleveraged property due to the magnitude of capital allocated for investment and their conservative investment policies.

PRICES PAID IN RELATION TO MARKET

Everyone has a favorite anecdote about some deal, domestic or foreign, which was either fantastically overpriced or an unbelievable bargain. However, we could find no general trend which showed the foreign investor to be significantly different from his U.S. counterpart in terms of prices paid. The consensus is that foreign investors will pay a price slightly above market in order to obtain a quality real estate investment that will preserve the investor's capital and appreciate with time. There may be the occasional deal which closed at a particularly high price because of bad judgment or the investor's external need to place his funds quickly. Yet most U.S. transactions happen in an open marketplace where the investor, or his intermediary, is reasonably well informed of price and value and acts accordingly in consideration of the investor's goals and objectives.

Exceptions to these general findings are the foreign individuals who attempt to use their overseas experience as their sole yardstick in the U.S. market. This kind of poor judgment is not confined to foreign investors; the Department of Housing and Urban Development's Interstate Land Sales Act was cre-

ated to help small domestic investors from falling into the same trap.

It is conventional wisdom that the entry of foreign investors into U.S. real estate markets has caused an upward pressure on prices because of increased demand and limited supply. None of the informants believed that the magnitude of foreign investment has been large enough by itself to have a significant impact of this nature on the market as a whole. However, the localized and fragmented nature of the market may explain some of the public perceptions of the foreign investor as a person "with a suitcase full of dollars." Further, the increased demand from domestic individuals and institutions for real estate investments combined with foreign investor interest clearly has influenced the apparent price rise and yield reduction associated with quality investment properties.

MOTIVATION OF SELLERS AND USE OF PROCEEDS

Most informants expressed the opinion that it made little or no difference to sellers whether the buyer was foreign or domestic. However, others' experience suggests that sellers often do react differently with foreign buyers or their representatives when it is known that the agent represents a foreign buyer and the parties have not worked together before. In these situations, sellers expect a higher price to compsensate for perceived longer transaction time and uncertainty as to the buyer's ability or commitment to close the sale.

Another issue cited was the difficulty of U.S. sellers to check credit and reputation easily to qualify a buyer and to determine risk in providing financing. First deals seemed most difficult for this reason and the foreign investor with a U.S. track record and/or established relationship with a U.S. seller has an advantage.

It is difficult to generalize about the use of proceeds by U.S. sellers, but it appears that most reinvest in other real estate. One instance was cited of a seller who just did not like the passive nature of real property investment and sold out to return to a small manufacturing business. Every situation appears to be unique. Perhaps payment of capital gains tax is the most common use of proceeds, unless the seller is able to defer taxable recognition of the gain by arranging the sale through a tax-free exchange, thus effectively reinvesting the proceeds in other real estate.

MANAGEMENT OF INVESTMENT

Almost all investments in U.S. real estate appear to be under some form of U.S. management. A few major foreign institutions have U.S. subsidiaries which act as if they were domestic, but for the most part the foreign investors utilize management firms, brokers, or investment advisors to monitor and control their holdings.

A number of U.S. firms, particularly major brokers, have actively sought foreign clients to add to their existing customer base. Other firms, such as the syndicators and many financial institution investment management

departments, have modified their "product" to appeal to foreign investors. Virtually all real estate acquisitions by foreign investors involve a U.S. intermediary representing the purchaser in the form of an investment advisor, in-house staff, or real estate broker. In addition, the sellers in most transactions are represented by a real estate broker.

LEVELS OF RETURN

Generally, foreign investors have been accepting lower levels of return because of differing investment goals and a more conservative risk/reward profile. Added to this is the fact that, although the foreign investor may pay market price to the seller, his actual cost may be higher due to the added cost of intermediaries both in the United States and abroad.

No typical level of current return can be cited, but a range of 4 percent to 6 percent cash on cash return on equity investment and 7 percent to 9 percent capitalization rate seems to be reasonable for existing, quality income-producing property investments such as office buildings and shopping centers. In view of the U.S. inflation rate and recent weakness of U.S. currency, this experience underscores information that foreign investors' objectives favor long-term security and/or appreciation over current yield. The internal rate of return over the holding period for income-producing property investment was estimated to average between 12 and 14 percent. This also supports the view of investor emphasis being on long-term property appreciation and total return on investment over time, since the difference between the internal rate of return and the cash on cash return is attributable to future growth in the property's cash flow and market value.

FUTURE TRENDS

The consensus is that more, rather than less, foreign investment in U.S. real estate will occur in the future. Despite the seemingly high U.S. inflation rate, long-term inflation has been a much more pronounced problem overseas. Moreover, constant dollar denominated debt is still readily available in the United States and, as such, makes inflation a positive rather than negative feature of percentage or inflation-indexed leased properties. Significantly, despite the benefit of fixed interest rate and long-term financing, most passive foreign investors are not expected to increase their use of U.S. debt in the future due to their preference for a generally risk-adverse investment strategy over the greater risk inherent in highly leveraged real estate investments. In addition, the sheer amount of capital committed by some foreign institutional investors to U.S. real estate favors free and clear purchases in order to place more funds per transaction.

In the future, the distribution of the origin of foreign investment is likely to remain broad-based, but relatively more capital is expected to come from Western Europe and the Middle and Far East. Geographically, foreign investment is expected to continue to focus on U.S. growth areas

in the "Sun Belt" and in other established metropolitan areas. These preferences will continue as long as foreign investors place a premium on preservation of capital and appreciation over the long term, and these areas continue to offer the opportunity to fulfill investor goals.

Pension funds and syndications are quite intriguing as they suggest a broader base of ownership in their countries of origin (usually European). Because the condition of the U.S. economy directly affects the participants in these pools, it has been suggested that the overall effect may be to increase international political stability. However, at some future point these pools may be repatriating their returns to pay their investors and beneficiaries. Unless the United States remains an attractive alternative for future funds, this could result in disinvestment.

"Flight capital," on the other hand, probably will never be repatriated. These funds are considered to be a permanent part of the U.S. asset base. Individuals seeking stability are "rolling over" returns into other U.S. real estate investments. Eventually, most individual or family investors are expected to join their investments personally in the United States rather than repatriate capital to their countries of origin. Moreover, many investors of this type appear to be using the United States as a haven for their working capital as well as for surplus funds they do not need now or in the foreseeable future.

Finally, in order to obtain quality investment opportunities, and as they become more experienced in the U.S. real estate market, more foreign investors are likely to become involved in development ventures which heretofore have been the purview of primarily Canadian development companies and a limited number of foreign institutional investors. However, although some more aggressive investors may pursue this course, others will retain their conservative posture and pay the price necessary to acquire less risky existing income-producing real estate.

GLOSSARY

Capitalization rate.--The interest rate which is considered a reasonable return on investment (based on both the investor's alternative investment possibilities and the risk of the investment); used to determine the value of real property through the capitalization process. The capitalization rate is employed as the denominator, and the property's annual cash flow after operating expenses but before debt service (principal plus interest) is the numerator in the valuation equation.

Cash-on cash return.--A method of evaluating investment opportunities in which annual debt service is deducted from project income to arrive at the amount of pre-income tax cash generated (equity income). This number is then divided by the amount of equity cash investment to arrive at the cash-on-cash return.

Current yield.--The expression as a percentage of the annual income to the investment; e.g., annual income is $5 and investment is $100, then current yield is 5 percent. Current yield is usually computed using net

income after debt service and income taxes expressed as a percentage of the equity investment.

Discounted cash flow analysis.--A method of analyzing investment opportunities in which annual cash flows are discounted and cumulated to arrive at their present value. This analysis necessitates predetermination of the expected investment holding period, and a discount rate which is indicative of the investor's required return on investment during the investment holding period.

Equity.--The total value of a property less any liens or encumbrances against it.

Internal rate of return (IROR).--A method of calculating discounted cash flow in which the true rate of return is established through a trial-and-error process; greatly facilitated by the use of a computer. This is also called "yield method."

Non recourse nature (nonrecourse).--A type of mortgage loan in which the borrower has no personal liability; the lender's only remedy in the event of default is foreclosure on the mortgage.

Chapter 15

GENERAL ECONOMIC CONSEQUENCES

M. Frances Van Loo*

The potential economic consequences of foreign investment in United States real estate are both diverse and complex. They range from driving up the price of local property to ameliorating our balance of payments difficulties, from tightening our credit markets to providing jobs for construction workers, to mention a few. The consequences in any particular situation depend on the precise nature of the foreign investment, its magnitude and geographic distribution, on the state of the U.S. economy, and on the reaction of U.S. policy-makers. It is the purpose of this paper to outline the major economic processes involved and to highlight the critical characteristics of foreign real estate investment which determine its impact on economic variables. These findings will then be used to clarify data requirements and to indicate where further work is needed to answer the policy questions being raised concerning the desirability of investment by foreigners in U.S. real estate.

The study will begin with a summary of the main findings. A more detailed economic analysis will follow, and then a discussion of existing and needed data will be included. Finally, some issues facing policy-makers will be suggested in the conclusion.

SUMMARY

At the present time, foreign investment in United States real estate is very small. Although no precise figures exist, estimates suggest it represents only a small fraction of 1 percent of the total United States capital market, described approximately as assets purchased primarily for investment.1/ While there has been a substantial in-

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1/White (1979, p. 59) reports that foreign investment in the United

crease in all types of foreign direct investment 2/ over recent years (e.g., as recently as 1972, the increase in the foreign direct investment position (equity plus debt to foreign parent) was estimated at $500 million, while in 1978 the comparable figure was $3.964 billion), 3/ it is a trivial percent of the total capital market and is dwarfed by our own foreign investment abroad which has been estimated at $165 billion for 1978. 4/

Its small size does not imply, however, the foreign investment in real estate has no impact on the United States economy. Prices are determined at the margin, that is, by increments in supply and demand. Clearly even a small amount of foreign investment will make a difference here. It will affect employment and capital markets in a similar way. But in determining the overall cause of any rise in the price of land, increased employment, and/or tighter capital markets, the magnitude of foreign investment must be compared with other factors, such as the rising proportion of domestic funds going into real estate as the result of such factors as inflation. Thus, while foreign investment can be viewed as a possible cause of such things as higher land prices, it most probably is dwarfed by other factors at the present time.

While foreign investment in real estate may have only a small effect on the United States economy as a whole, its impact on local markets may be significant. Real estate markets can be characterized as having some inflexibility in supply and, therefore, any increase in demand for existing property will cause some increase in prices, at least in the short run. A similar price rise is likely to occur in building

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States is $30 billion compared with a total capital market of $3,500 billion, or less than 1 percent. Commerce Department figures in the Survey of Current Business, August 1979, put the foreign direct investment position at $27.7 billion in 1975 and $40.8 billion in 1978, with real estate about 2 percent of total foreign direct investment. While the definition of real estate used here is a limited one, including only investment in real estate by people such as real estate operators, agents, and developers, and does not include real estate purchased for such purposes as agricultural production and mining, even a substantial increase in the real estate percentage would still make it only a fraction of 1 percent of the total U.S. capital market.

2/ "Foreign direct investment" is defined as ownership or control, directly or indirectly, by one foreign person of 10 percent or more of the voting securities of an incorporated U.S. business enterprise or an equivalent interest in an unincorporated U.S. business enterprise, including a branch.

3/ Survey of Current Business, "Foreign Direct Investment in the United States," August 1979.

4/ New York Times, April 20, 1979

materials and raw land if the foreign investor is developing new hotels, shopping centers, or homes, and there could be an impact on local labor markets and property tax collections as well. Thus, even when foreign real estate investment is small on a national scale, its impact on local areas can be substantial.

Furthermore, although foreign investment in real estate is very small at the moment, it is a legitimate policy concern to consider what its impact would be if it were considerably larger. In general, foreign investment probably raises the level of total investment, thereby increasing long-run economic growth. It also probably increases employment and exerts a positive effect on the short-run balance of payments by providing much-needed foreign exchange. Tax collections from the federal corporate income tax and local property taxes also are likely to be higher. On the other hand, foreign investment is likely, at least in the short run, to cause some increase in the general price level through increasing the cost of housing and business property, and it may cause higher interest rates and decreased competition in the real estate industry.

To be more specific, the economic consequences of a large amount of foreign investment will depend on a number of factors such as the nature of the foreign real estate investment, the state of the economy, and the reaction of U.S. policy makers to the capital inflow. For example, the effect on total investment, and hence long-run economic growth, depends on the extent to which the foreign investment develops new real estate projects or merely purchases existing property, whether it stimulates additional investment elsewhere in the economy through a process of backward and forward linkages, and whether the proceeds of the sale are used to reinvest, to increase consumption, or to increase savings which are not invested. Furthermore, the more that the economy is operating below full capacity, the more any increase in demand will be translated into higher employment; the closer it is to full capacity, the more any increase will give rise to price increases.

Another critical factor in determining the effect of foreign investment on the economy is the responsiveness of various factor markets to increases in demand. The less quickly and completely they respond, the more that prices will rise. Prices also are more likely to be affected, the more that foreign real estate investment is concentrated in a few locations.

The amount of borrowing on U.S. capital markets is another determinant of the economic consequences of foreign investment. The larger the percentage of the total price that foreign investors borrow, the greater the chance that interest rates will rise. Alternatively, if they bring in all of their own capital from abroad, assuming that the Federal Reserve does not neutralize the capital inflow, total money supply increases and interest rates could decline. The amount of funds they bring from abroad also affects the balance of payments.

If foreign investment stimulates imports because, for example, it requires certain foreign goods in its production, or if the firm receiving the foreign investment chooses to export more of its goods than a domestic firm would, both the balance of payments and tax collection will be affected. Repatriation of profits and the tendency of investors to take investments out of the country in response to changing market conditions are other important variables determining foreign investment's impact on the balance of payments.

Federal tax collections are affected by the nature of the tax treaties the United States has with many foreign countries. In general, these have the effect of decreasing tax revenues from what they otherwise would have been. However, to the extent that total investment has increased, tax collections would increase, so the overall impact is indeterminate a priori.

Finally, foreign real estate's impact on income distribution depends on how close the economy is to full employment and how widely wealth is held in this country. If foreign investment causes an increase in total demand and thereby provides jobs for the unemployed, it aids the poorer segment of the population, but if it causes prices to rise on real estate, owners of capital benefit relative to the rest of the population.

Thus, foreign real estate investment's impact on the United States economy depends critically on the size, nature, and distribution of such investment, the state of our own economy, and the response of our policy makers to the capital inflow. An accurate assessment of the desirability of such investment requires information on all of these. However, while considerable data on the United States economy is available (particularly the macroeconomic variables) and policy response is something which can be controlled, there is very little historical data on foreign real estate investment. Thus, determining the economic consequences of this investment in the U.S. is virtually impossible at the present time.

This report therefore takes a conceptual approach, analyzing the economic consequences under various specified conditions. This has the advantage of clarifying the factors involved, but any weighing of costs and benefits must await the data which permit quantitative estimates. These make it possible to both compare the magnitudes involved and take into account the interaction of the various factors.

The time series data which exists at the present time gives primarily the dollar value of foreign-owned real estate purchases where real estate is defined to include purchases made by real estate operators, agents, and developers but not purchases for such other business purposes as agricultural production or mineral extraction. However, as required by the International Investment Survey Act of 1976 and the Agricultural Foreign Investment Disclosure Act of 1978, considerably more information is being collected at the present time. While it

remains to be seen how this information will be compiled and made available, its collection represents a significant improvement over the past.

Data being collected which will be helpful include the magnitude of foreign real estate investment, the amount of foreign funds involved, the extent to which the foreign corporation purchases an existing property or develops a new one, the degree to which profits are repatriated, geographical location, employment, and taxes paid. With this information, policy questions such as the following can be studied:

1) Has foreign investment replaced or supplemented U.S. domestic investment?

2) Has foreign investment in real estate increased or decreased domestic employment?

3) How has foreign investment in real estate affected the balance of payments? To what extent are profits being repatriated and to what extent does foreign real estate investment tend to stay here even under deteriorating market conditions?

4) Has foreign investment in real estate caused the interest rate available to U.S. borrowers to be higher than it otherwise would have been because of foreign borrowing on the U.S. capital market?

While some time will have to pass before a sufficient time series can be compiled, the data now being collected, with a few exceptions, should be sufficient for answering the main policy questions being raised. In the meantime, however, policy makers must try to answer these questions without the benefit of quantitative analysis. The theoretical framework which follows can be an important aid in decision-making in these circumstances, as well as indicating the direction which quantitative analysis should take when the necessary data becomes available.

POSSIBLE ECONOMIC EFFECTS

Foreign investment can have a large number of effects on the economy of the capital-receiving country. They are being divided for the purposes of this report into effects on the macroeconomy as a whole and selected regional effects. Explicit consideration of both issues is considered important because the small size of foreign investment in real estate relative to the economy as a whole at the present time means that its impact at that level may be indiscernable. While consideration is given to the effects of a larger amount of foreign investment, any conclusion that small quantities have little impact could be misleading because of their potentially large impact on particular markets where foreign investment is concentrated. For example, the

large investments being made by foreigners in the Sunbelt may be having a significant impact on rent, land prices, and employment in these areas, especially in the short run, while their impact on the overall United States economy is negligible.

Effects on the Macroeconomy

The effects of foreign investment in real estate can be divided into eight broad areas: domestic investment, saving, and consumption; employment; the price level; money demand and supply, and interest rates; the balance of payments; competition in the real estate market; Federal, State, and Local tax collections; and income distribution. While these issues are inextricably intertwined, it is useful to focus attention on each one separately to better understand the key variables influencing each one, and thereby facilitate the identification of policy instruments and issues for further study.

Domestic Investment, Saving, and Consumption

Foreign investment may represent a net addition of resources going into investment. As such, it can be viewed as stimulating long-run economic growth. It is possible, however, that foreign investment will simply replace domestic investment, with the domestic funds going into increased consumption or into savings which are not reinvested. If they go into consumption, total demand in the economy will be higher with resulting higher national income and employment and/or a higher price level, depending on how close the economy is to the natural rate of unemployment (defined as approximately 5.5 percent at the present time).5/ In this dimension, higher consumption has the same effect as higher investment. However, investment has a much larger impact on long-run economic growth than consumption. Moreover, if the only effect of an increase in foreign investment is a rise in savings which are not reinvested, there is no net impact on either economic growth or aggregate demand.

The effect of foreign investment on investment, savings, and consumption thus depends on the use of the proceeds from the sale of the property to the foreigner. The greater the degree to which the seller of the property to foreigners (and all subsequent sellers in the chain of sales initiated by the foreign purchase) reinvests the funds, the greater the stimulation of both aggregate demand and economic growth. If funds go into increased consumption, aggregate demand will rise, while if they go into savings which are not reinvested, the foreign investment will not have had an impact in either of these dimensions.

5/ The term "natural rate of unemployment" is being used with increasing frequency to denote the level of unemployment below which the economy cannot move without causing a substantial increase in inflation. See Dornbusch and Fischer (1978) for a more extensive discussion of this concept.

Another way in which foreign investment can affect investment is through a process of linkages. Linkages, as developed by Hirschman (1958), denote a process whereby one investment triggers investment in another area. The primary linkages stimulated by foreign investment in real estate are likely to be backward into the construction and construction supply industries. This will occur whenever foreign real estate investment is of a development nature (rather than purchase of an existing building on raw land) or when funds from a sale to foreign investors are put into development. The extent and nature of these linkages will depend on the type of development undertaken (office buildings use different construction materials than a residential housing development) and whether the construction and construction supply industries are close to full employment. (The closer each of these industries is to full employment, the more likely is new investment in the construction industry.) Thus, the nature of the foreign investment itself is a second major determinant of the way foreign investment affects investment and hence aggregate demand and economic growth.

In addition, foreign investment affects investment, consumption, and saving through its impact on total demand. These variables are usually modelled as being some function of demand or changes in demand, so that if foreign investment causes an increase in total demand, they will all be higher.6/

Thus, foreign investment's impact on investment, consumption, and saving is a complex one and cannot be determined a priori. Although people knowledgeable about foreign real estate investment contacted by John McMahan Associates suggest that most sellers reinvest in real estate (Azrack and Roberts, this report), it is clearly not possible for them to know the disposition of funds several transactions down the line. Moreover, this is just the first step in a process which also includes linkages and changes in total demand.

Econometric studies are a preferable way to determine the effect of foreign investment on domestic investment, saving, and consumption. By incorporating the dollar value of such investment into investment and consumption equations, the coefficient on foreign investment will indicate whether such investment has stimulated investment and consumption and, if so, by how much. A model which accounts for time lags is desirable to clarify the varying impact over time.

The studies which do exist do not agree on the precise nature and magnitude of foreign investment's impact on domestic investment, saving, and consumption,7/ and the methodological issues involved

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6/ See Van Loo (1977) for a more complete discussion of this process.

7/ Early development models simply assumed an increase in investment equal to the foreign capital inflow. [See, for example, Chenery and Strout (1966) and Rosenstein-Rodan (1961).] In recent years, however,

are too complicated to include here. Suffice it to say that more research is needed to answer this question and to identify the critical factors which influence foreign investment's effect in any particular situation.

To understand the impact of the real estate component of foreign investment, accurate data are needed on the inflow and outflow of such funds on a regular basis. While these are not available at the present time, annual publication of data being collected pursuant to the International Investment Survey Act of 1976 should greatly improve this situation. In addition, a better understanding of the nature of foreign investment's impact could be obtained if data on the type of development (e.g., office buildings versus homes) were available. For example, a sectoral analysis with input-output tables could be used to increase understanding of the nature and extent of new investment which arose as a result of the foreign-stimulated demand.

Employment

The effect of foreign investment in real estate on the level of employment depends on the state of the economy, the precise nature of the foreign investment, and the use of proceeds from the sale. The closer the economy is to the natural rate of unemployment, the smaller the chance that foreign real estate investment will affect the level of employment. Any increase in demand caused by foreign investment in the form of increased investment or consumption will be less likely to cause people to enter the labor force because the remaining unemployed are likely to be less desirous or less able to work. Furthermore, employers will be less likely to train the unemployed because of their relatively low productivity.

The recent surge in foreign real estate investment has continued through periods of tight and slack labor markets, and thus probably has increased employment somewhat during the slack periods. The extent of its stimulation of employment cannot be known, however, without data on its magnitude. It could then be incorporated into the employment equation of an econometric model of the macroeconomy. Such data as do exist suggest that foreign real estate investment is so very small that its impact on employment nationwide probably is insignificant. A significant impact on particular markets cannot be ruled out, however, and therefore the collection of foreign real estate investment data by location would be extremely useful.

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studies on the impact of foreign investment on domestic investment, saving, and consumption have seriously questioned this view. See Rahman (1968), Leff (1968), Gupta (1970), Griffin (1970), Griffin and Enos (1970), Landau (1970), Papenek (1972), Weisskopf (1972), Voivodas (1973), Chenery and Carter (1973), Areskoug (1973), Papanek (1973a, 1973b), Newlyn (1973), Islam (1973), Alamgir (1974), Bartels (1975), Areskoug (1976), Bose (1976), and Van Loo (1977).

For a deeper understanding of the employment consequences of foreign real estate investment, we need information on the nature of such investment and the use of the proceeds from the sale. For example, if either the foreign investment or the use of the proceeds from the sale are of a development nature, employment is likely to increase to some extent, the amount depending on the bottlenecks which are encountered; if there is a shortage of plumbers, the employment of electricians and carpenters may be affected as well. Thus, the nature of the increased demand arising from the foreign investment and something on the state of the labor markets involved would greatly facilitate assessing the impact of foreign investment in real estate on the level of employment. This would require data on the dollar value of the foreign investment, and also on its form (development versus purchase of existing property). Further, if it was development, knowledge of its nature (hotels and office buildings versus homes) could help in identifying the sectors affected. If existing property is purchased, comparable information is needed on proceeds from the sale.

Prices

The effect on real estate prices of any increase in aggregate demand arising from foreign real estate investment will depend critically on the supply response; the larger and more rapid this response, the smaller will be the increase in prices. In general, the supply response in real estate is likely to be less than in other forms of investment because land, which is an important component in any real estate investment, is in fixed supply. Beyond this, however, a critical factor is whether the foreign investment is itself supply-creating as well as demand-generating, i.e., whether it brings about new development or whether it merely involves the purchase of an existing property. If the foreign investment is itself of a development nature, or proceeds of the sale to a foreign investor are used to undertake a new real estate project, supply as well as demand has been expanded and price increases will be smaller (or possibly not rise at all) than if the foreign investment involves the purchase of an existing asset. While prices are likely to rise in the short run due to the increased demand for land, in the long run they will be lower than they would have been without foreign investment because of the increased supply. In addition, the amount of the price increase if a development project is undertaken will depend upon the short-run tightness of the factor markets supplying these projects (e.g., the lumber, steel, and cement goods market, and the contractor, carpenter, and electrician labor market) and their supply elasticity.

The overall impact of foreign real estate investment on prices can be obtained by the inclusion of a price equation in a macroeconometric model. A deeper understanding of any price changes, however, would require more precise knowledge of the nature of foreign real estate investment. For example, data concerning the percent of foreign real estate investment which is development in nature would be helpful. On the basis of their survey, McMahan Associates estimates that the ratio of development investment to investment in existing property

is about 50/50, but they note that the ratio varies dramatically between countries, with Canadians being very heavily involved in the development portion.8/ Furthermore, attempts to determine what types of labor and materials are affected can be only guesses without data on the form of development investments (e.g., office buildings versus homes). Even if assumptions are made on the affected labor and materials, additional assumptions are necessary on the size of foreign demand for these factors. And finally, only limited information on price responses (elasticities) in these industries is available.

While the impact of foreign investment in real estate on the overall price level and the rate of inflation in recent years cannot be determined with any degree of certainty, it probably is small because of the relatively small size of foreign investment and because some of it has been supply-creating.

Money Demand and Supply and Interest Rates

Foreign investment can affect the demand for and supply of money and hence the rate of interest. If all the funds necessary for the purchase are brought into the United States by the foreign investor, the supply of money will increase in the United States unless the Federal Reserve counters this by decreasing the supply of dollars held by American citizens. If this is not done, the effect on the economy is a stimulating one. A more usual occurrence, however, is for the foreign investor to borrow some of the purchase price on the United States capital market. Although there is some difference of opinion on the extent of leveraging, debt appears to range from 40 to 80 percent of investment cost.9/ Use of debt is due at least in part to foreign restrictions on capital outflow, but it also is encouraged by the attractive terms of United States debt instruments (such as low interest rates, compared with those in other countries, and its nonrecourse nature).10/ An important limitation to leveraging is the desire of the foreign investor to reduce volatility; the larger the proportion of debt, the greater his fixed payments, which in bad times cut substantially into profits. This appears to cause some companies to reduce their debt/equity ratios, but not to eliminate debt entirely. Thus, foreign investors in the United States real estate appear to be exerting some demand in the United States money markets.

8/ Azrack and Roberts, this report.

9/ Azrack and Roberts, this report indicates that foreigners typically have lower debt to equity ratios than their counterparts, ranging from 40 to 60 percent. White, on the other hand, claims that foreigners' leverage more heavily, with 80 percent debt-equity ratios not being uncommon.

10/ Azrack and Roberts, this report.

To determine the impact of foreign real estate investment on interest rates, it is necessary to compare the magnitude of the inflow of foreign funds with the borrowing being done on United States capital markets. If the inflow is larger, foreign investment is exerting a downward impact on interest rates, while if borrowing is larger, it is causing them to rise.

It should be noted that even if borrowing by foreigners exceeds the inflow of foreign funds, its magnitude may be so small, compared with the overall size of the money market, that its impact on interest rates is insignificant. This is likely to be the case at the current time. However, it would be useful to test this hypothesis.

Balance of Payments

The initial effect of foreign real estate investment on the balance of payments is clearly positive, i.e., it adds to the credit side of our international accounts. The effect over a longer period, however, depends on a number of factors. First, it depends on the extent to which foreigners import personnel and/or machinery along with their foreign investment. In the case of real estate, these are both likely to be small. So the overall effect of foreign real estate investment on the balance of payments is likely to be more positive than other forms of foreign investment. Second, production of goods for export would further enhance the balance of payments credits. Foreign investment in urban real estate is likely to have little, if any, impact on exports, although investment in farms could (if it caused an increase in the export of food), and so could investment in timberlands. In addition, exports and imports could be affected indirectly through foreign investment's impact on aggregate demand. Imports, usually thought to be a function of the level of income, could be expected to rise as a result of higher aggregate demand. Moreover, if the rise in aggregate demand were to occur during a period of high levels of employment and aggregate demand, prices would probably increase. If they were to rise more rapidly than prices abroad, imports could be expected to rise and exports to fall. Thus, the indirect effect of foreign investment on exports and imports could dampen the positive balance of payments' effect of the original inflow of foreign funds.

The impact of foreign real estate investment over the long run also is affected by the extent to which profits are repatriated and investments sold. So-called "flight capital" is much less likely to produce earnings that are repatriated and to ever return the principal to the foreign country than investment which enters the United States in response to market conditions (such as high returns arising from a favorable exchange rate and attractive long-term capital gains). Thus, while the initial impact of foreign investment in real estate on the balance of payments is almost surely favorable, the long-run effects are less certain. An assessment of its impact requires, at a minimum, knowledge of the magnitudes involved. In addition, a more complete understanding requires knowledge of the extent to which

the foreign investor needs imports to function, and some estimation of the likelihood of repatriation of earnings and sale of the investment when market conditions change. Other critical variables include the tightness of the labor and other factor markets and the U.S. rate of inflation relative to the rest of the world.

Finally, it should be noted that in a world of freely and instantaneously adjusting exchange rates, any impact on the balance of payments would be neutralized,11/ and foreign investment's impact would be primarily of academic interest. In the current world of a managed float, however, the above considerations are relevant, although the overall impact will be smaller in size than in a world of fixed exchanges.

Competition in the Real Estate Industry

At the present time, the real estate industry is largely a local industry. As such, it retains many of the elements necessary for perfect competition--such as a large number of firms, no one of which is able to determine prices. With the entry of foreign investors (who are more likely to be large than domestic investors), there is some possibility that large companies will come to control a larger share of the real estate market, thereby decreasing competition. On the other hand, the entry of foreign investors may cause competition to increase. While it is beyond the scope of this paper to document any changes which may have occurred, the possibility of decreased competition was raised by a practitioner in the field 12/ and deserves study because of the decrease in social welfare which imperfect competition implies.

Federal, State, and Local Taxes

It is not possible to estimate the impact of foreign investment in United States real estate on Federal tax collections at the present time. Any increases in real estate prices arising from the increased demand and increases in the quantity of property to be taxed as a result of development by foreigners would both cause an increase in the Federal corporate profits tax. However, the availability of special provisions in the tax code for foreigners will dampen those increases. Determination of the net effect on taxes would be difficult under any circumstances because it would require an assumption about the extent to which the foreign investment represents investment which would not have occurred otherwise. But it also requires data on the magnitude of foreign real estate investment, the percent coming in under a tax treaty and the nature of the provisions of that treaty, and the percent

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11/ See Penner (1966) for a more complete discussion of this issue.

12/ Ranne Warner of Commercial Union Properties, Ltd. raised this issue in a talk on foreign investment at a meeting of U.S. Department of Agriculture Contractors, Americana Hotel, Arlington, Virginia, November 1 and 2, 1978.

which is considered to be an investment rather than a business or trade.13/ In general even with these data, it will be difficult to assess foreign investment's overall impact on federal tax collection.

Foreign real estate investment also affects State and Local tax collections. To the extent that they increase demand and hence drive up the price of real estate and when they create new property through development, foreign investors cause property tax collections to increase. Although there have been allegations that foreigners are causing a drop in sales tax collection because they are more likely to export goods produced on their land such as food,14/ timber, and minerals, this greater proclivity to export has not been documented to the best of my knowledge. Furthermore, lower sales tax collections may not be an undesirable result when compared with other measures to deal with the balance of payments deficit--such as restrictions on imports.

Some empirical studies of the effect on State and Local tax collections would be useful because it would make possible a more accurate weighing of the various costs and benefits of foreign investment. Because the effects may differ substantially among the States, it is important that the study be sufficiently broad based.

Income Distribution

Perhaps the clearest impact of foreign investment in United States real estate is its effect on income distribution. As foreigners bid up the price of land and other forms of real property, people who already own real estate are the beneficiaries and those who are trying to buy in are the losers. Thus, in the case of homes it generally is older people who are gaining from the higher prices and younger people who are hurt. More generally, in the long run, owners of all forms of capital are benefiting. Those who do not own stocks, bonds, or real estate against which they can balance off the higher costs of all goods and services they buy, including higher real estate prices, are hurt. Although the small size of foreign real estate investment at the present time implies that the income distribution effects arising from this foreign investment are small, a larger inflow of foreign funds could have important distributional consequences. These effects are mitigated to the extent that foreign investment is of a development nature. Rises in the supply of improved real estate property mean prices rise less than they otherwise would, so the income distribution effects are less.

13/ For a discussion of tax provisions affecting foreign investors in land, see Abramson, Gertel, and Lewis (1978).

14/ California Assemblyman Rick Hayman of Fresno, on CBS "Sixty Minutes," November 19, 1978.

Foreign real estate investment also affects income distribution through its impact on employment. In time of slack demand, development-type real estate investment will increase employment, thereby improving the position of the unemployed portion of the population relative to those who already have jobs. When the economy is close to full employment, prices and not employment are affected, so there is little impact on income distribution per se.

Selected Regional Effects

As discussed above, the effect of foreign real estate investment on any economic variables at the macrolevel at the present time is likely to be extremely small, if there is any impact at all, because of the small size of the foreign investment relative to the total real estate and total capital market. Although the effects which might be expected from a larger capital inflow have been discussed to facilitate the work of those who may disagree with this judgment, for it is admittedly based on extremely unreliable figures, it is this author's judgment that most of the substantive cases for concern over foreign investment's impact on the economy at the present time rest on its impact on local areas where it is concentrated.[15/] Hence, while data are lacking here as well, it seems important to outline the possible effects, including evidence where it may be available. This paper concentrates on effects on urban real estate, as another paper in this study by Jansma et al. explores the effects on rural areas.

Prices

Foreign investment in urban real estate appears to have been concentrated in the Sunbelt with a few exceptions such as Washington, D.C., New York City, and Minneapolis, Minn. Investment in these areas, where real estate prices are high, is indicative of the long-run nature of foreigners' interest; they are seeking long-term capital appreciation rather than short-term profits. But it also means that the effect on real estate prices is likely to be greater than it would be if they were investing in a wider range of areas around the country where demand is not already so close to the point of existing fixed supply. Even if the foreign investment is of a development nature, the employment markets generally are tight in these areas, so to obtain the work force necessary higher wages are offered, which becomes reflected in higher costs and prices.

The overall increase in price depends critically on the supply response. If higher real estate prices cause more building to be done, and higher wages bring more people into the local labor market, the effect of the increased demand is less. But clearly in the short run, some price

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[15/] Concern also undoubtedly stems from some of the effects which would occur if foreign investment were larger.

and wage increases will occur because supply adjustments are not instantaneous. These price increases must be weighed against the long-run benefits where prices will rise less than they otherwise would have (or not at all) because of the increase in supply which the additional investment has produced.

Ultimately, of course, there is a limit to the possibility of supply increase, given an existing state of technology and institutions. There is only a limited amount of land available, for example, within a downtown area that is served by public transportation, has space to park cars, or is accessible by walking. A similar argument can be made in the case of residential housing. Some substitution can be made--such as moving to the suburbs, but ultimately consideration of the time and money costs of transportation will lead people to pay the higher housing or rental costs. Supply response in the form of taller office buildings or apartments may be blocked by zoning laws, height limitations, and other regulations. Thus, the overall effect probably is higher prices.

Employment

The impact of foreign real estate investment on employment is almost certainly positive if it has any effect at all. In times of slack demand, an increase in foreign investment stimulates aggregate demand, thereby raising the demand for labor. These effects will be concentrated in the construction industry and will be larger, the greater amount of the investment which is development in nature. But to the extent that foreign investment raises the level of total demand, there will be general employment effects as well. In periods when the economy is close to its natural rate of unemployment, there will be little effect on employment at all.

Because of its nature, foreign investment in real estate probably very seldom causes the replacement of a domestic worker by a foreign one. Real estate property management is very localized in nature and requires someone who is knowledgeable about local laws and customs. Foreign purchases of homes are usually for people already here or who would be coming here regardless of whether they could own land, and it does not involve employment in the usual sense. While some foreigners may come to manage farms or mining operations, the numbers involved are very small, and evidence seems to suggest that foreign investors usually use domestic managers.16/

SOURCES OF INFORMATION ON FOREIGN REAL ESTATE INVESTMENT

In the previous section, the macroeconomic consequences of foreign real estate investment have been discussed primarily in theoretical

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16/ Evidence on local managers is reported in Jansma, et al., this report.

terms because of the lack of data available for quantitative analysis. This discussion, has, however, highlighted the data which would be necessary to assess the desirability of such investment. Included would be the purchase price; the amount of foreign funds and the amount borrowed on the U.S. capital market; the amount of profits and proceeds from any sales which are repatriated; the geographical distribution of investments in this country; whether new development or purchase of existing assets is involved; the amount going into various forms of real estate such as farmland, hotels and office buildings, and private homes; the country of origin of the foreign funds; employment; exports and imports; and the taxes paid at Federal, State, and Local levels.

In this section, the existing data will be discussed. In general, prior to passage of the International Investment Survey Act of 1976 information on foreign real estate investment was very limited. The Act and the subsequent Agricultural Foreign Investment Disclosure Act call for greatly expanded data collection, but it is too early to fully evaluate their adequacy beyond commenting on the information requested on the forms. The section begins with the traditional sources of information, and then moves on to consider the forms being used to collect information required by the 1976 and 1978 acts.

National Accounts and Balance of Payments Statistics

These customary sources do not include a breakdown of foreign investment into real estate and therefore cannot be used to answer any policy questions that are concerned with this specific type of foreign investment. For example, questions concerning the magnitude of foreign purchases of U.S. farmland or homes in urban areas, the amount of foreign borrowing on U.S. capital markets to finance real estate investments, and the nature of balance of payments effects coming from real estate investments cannot be answered from these sources.

State and Local Records

The principal sources of information on land ownership are state and local records which record land transactions. These data have serious limitations for statistical analyses on foreign ownership questions, however, because they are seldom aggregated and usually do not require that the owner's citizenship be recorded. Furthermore, the legal owner is not necessarily the beneficial owner. Finally, since the primary purpose of land records is to protect the interests of the parties involved in the transaction, little or no information is included on sources of financing, export and import consequences, taxes paid, and so forth.

Industry and Trade Administration (ITA), U.S. Department of Commerce

The Office of Foreign Investment in the United States (OFIUS) of the Industry and Trade Administration develops estimates of the magnitude

of foreign direct investment including real estate (e.g., Foreign Direct Investment in the United States, U.S. Department of Commerce, ITA, Dec. 1977, and ITA 76-138, Aug. 1978). This agency obtains information from documents and reports that are publicly available, and also from other federal agencies such as the Bureau of Economic Analysis, the Bureau of the Census, and agencies of the U.S. Department of Agriculture. The reports contain information on the total value of the transaction, but do not include any information on such things as the source of financing. In addition, the figures on real estate are generally considered to be an underestimate because many foreign real estate investments are not reported in the press or other sources of public information, and because they do not separate out the real estate component of businesses not included in the real estate classification code.

Internal Revenue Service (IRS), U.S. Department of the Treasury

Several reports which must be filed with the IRS contain some information on foreign investment in U.S. real estate. These include Form 1120F (Foreign corporate income tax return), Form 1120 (U.S. corporate income tax return), and Form 1040 NR (Non-resident alien tax return). Much of the information from these reports is not published, however, and even if it were, it is likely to be of limited value because of the particular tax-related definitions used. Furthermore, these reports can provide information only on the magnitudes involved.

Selected In-Depth Surveys

Detailed studies of foreign real estate investment in Hawaii, Iowa, and Colorado are included in the Report of the Secretary of Commerce to the Congress in Compliance with the Foreign Investment Study Act of 1974.17/ They provide estimates of the magnitudes involved, country of origin of the legal owner in some cases, type of industry into which the foreign investment goes, some information on the financial arrangements and prices paid, and some attempt to discern the motive of the foreign investor. The Iowa study is based on data from a survey, and the Colorado one on phone calls and interviews with real estate brokers, bankers and others knowledgeable about foreign real estate investment. Only the Hawaiian study uses data from official sources, and its scope is limited primarily to large investments. Thus, while these studies provide helpful insights, they cannot be used as the basis for statistical analysis.

17/ Foreign Direct Investment in the U.S., Report of the Secretary of Commerce to the Congress in Compliance with the Foreign Investment Study Act of 1974, April 1976. Volume 1, pp. 185-7, provides a brief summary of these studies. Their full text is included in Volume 8, Appendix L of the same report and also in Foreign Investment in U.S. Real Estate, U.S. Department of Agriculture, Economic Research Service, 1976. (See Curie et al., Gertel, and Waples.)

A 1979 report[18/] issued by the Department of Housing and Urban Development covers foreign direct investment in major sectors of the U.S. economy, including real estate. Acknowledging data limitations, this report identifies Canada and the OPEC nations as leading foreign investors in U.S. real estate during 1977 and 1978. While most foreign real estate investments were found to have located in the Sunbelt states, a heavy concentration was also found in New York City. The findings of this report are generally consistent with those contained in this report.

A special survey of foreign investment in U.S. real estate is included in this report. To summarize the results of the study by Azrack and Roberts of John McMahan Associates, "flight capital" is an important part of foreign real estate investment in the U.S., implying a low tendency to repatriate earnings or the proceeds of any sale. Current yield and tax considerations were relatively unimportant factors encouraging foreign investment, but long-term appreciation was. The most common forms of investment reported were in shopping centers and office buildings in large urban areas. If debt financing is used, it is almost always U.S. in origin, apparently because of lower interest rates here, its general availability, and its non-recourse nature, in addition to foreign restrictions on overseas debt instruments. Debt-to-equity ratios are reported to be lower for foreign investors than their comparable U.S. counterparts in order to reduce volatility and increase stability. No evidence of foreign investors paying a higher price was found once quality was taken into account. Most respondents believed that sellers used proceeds from the sale to reinvest in other real estate. The overall magnitude of foreign real estate investment cannot be discerned from this type of survey.

BE 605, 606, and 607 Forms, Bureau of Economic Analysis, U.S. Department of Commerce

These forms, as required by the International Investment Survey Act of 1976, require firms to identify the industrial classification of the foreign parent and the U.S. affiliate, and to provide a detailed record of transactions between the U.S. corporation and the foreign parent. The information from these forms is useful for balance of payments analysis

Benchmark Survey, Bureau of Economic Analysis, U.S. Department of Commerce

This comprehensive survey of all foreign direct investment in the U.S. was made in 1959, 1974, and will be undertaken again next year

[18/] U.S. Department of Housing and Urban Development, Office of Community Planning and Development, "The Impact of Foreign Direct Investment on U.S. Cities and Regions," February 27, 1979.

(1980). 19/ All U.S. business enterprises which were controlled by a foreign person during any part of the survey year are required to file form BE-12, unless their revenue was less than $100,000, in which case they only needed to fill in Part I of the form. Foreign control is defined for purposes of this survey as direct or indirect ownership of ten percent or more of the voting stock of an incorporated U.S. business enterprise, or equivalent interest in an unincorporated U.S. business enterpirse. In general, this survey is expected to include all the items necessary for the economic analysis outlined above with the exception of real estate purchased for personal use.

However, its past infrequency and irregularity make its use in time series analysis for even the business component impossible. Although the International Investment Survey Act of 1976 requirement that this survey be made every 5 years represents an important improvement, that is not frequent enough to allow statistical analysis of the economic consequences of such investment.

BE-15 and BE-13 Forms, Bureau of Economic Analysis, U.S. Department of Commerce

To meet this need, an annual survey was begun with the first forms due in January 1979. Filing of form B-15 is not required of firms whose total assets, net sales, and net income are less than $5 million, nor of banks, and therefore is less comprehensive in its coverage than the Benchmark Surveys.

Compilation of information from these forms in not yet complete, so it is not possible to fully judge the adequacy of this undertaking for analysis of the issues noted above. At this stage it appears that acres and value of property net of plant and equipment will be reported by industry classification according to the major activity of the reporting entity. The information on the forms will be on a consolidated basis including all affiliates in which a reporting corporation owns 50 percent or more of the outstanding voting stock. For example, a consolidated report falling under the classification of mining may report land actually used for industrial, residential, and timber purposes as well as for mining. Thus, the data on property will be, for an undeterminable proportion, for real estate used for purposes other than that of the industry group under which it is reported. Value of property and possibly also acres by specific major uses will however be reported in the 5-year benchmark surveys.

19/ Results of the 1974 survey are contained in Foreign Direct Investment in the U.S., Report of the Secretary of Commerce to the Congress, volume 2.

The BE-13 form is used to record all new foreign involvement (defined as the purchase by a foreigner of 10 percent or more interest in voting securities) in U.S. firms as of January 1, 1979, and therefore will contribute significantly to the reliability of U.S. data.

Agricultural Foreign Investment Disclosure Act Report, Agricultural Stabilization and Conservation Service, U.S. Department of Agriculture

This Act provides for the collection of data on foreign ownership of U.S. agricultural land, and as such, will make it possible to examine the impact of foreign real estate investment on this particular sector. All land with a 5 percent or more foreign interest must be reported within 180 days of the effective date of the reporting section of the Act, if it was held before this time, and within 30 days after the transaction if it took place subsequently. Responses are due in August 1979, with the first report to Congress to be made in November of the same year. Information required includes the estimated current value as well as purchase price, the date of acquisition or transfer, and the name and country of origin of the owner. In addition, it requires specification of land use. Analysis can therefore be made of land used for crops and pasture separately from land used for forest and timber. Thus, information will be available for quantitative estimates of the magnitudes involved. However, analysis of the balance of payments, interest rate, and tax effects will not be possible because the forms do not ask for information on exports and imports, the source of funds used in financing, or taxes paid. Analysis will also be limited since the quality of the land purchased will not be known. For example, comparison of prices paid by foreign investors and farmers is difficult, if not impossible, unless the quality and productivity of the agricultural land is known. Further, because the data are to be available for public inspection, there is some concern that beneficial owners will not be recorded. See Zagaris[20/] for a more complete discussion of this issue, as well as the contents, rationale, and other potential consequences of this Act.

Current Issues in Data Adequacy

The reporting requirements mandated by the International Investment Survey Act of 1976 and the Agricultural Foreign Investment Disclosure Act of 1978 improve significantly the items of information available. Thus, to some extent our ability to make quantitative estimates is a matter of time until a sufficient period has passed for an adequate time series to be available. However, as noted above, annual data on

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[20/] Bruce Zagaris, "The Agricultural Foreign Investment Disclosure Act of 1978: The First Regulation of Foreign Investment in United States Real Estate," Working Paper Number 65, U.S. Department of Agriculture, Economics, Statistics and Cooperative Service, Natural Resource Economics Division, Nov. 1978.

acres and value of property will be obtained by major activity of the reporting corporation and its affiliates, not by actual use. The elimination of information of specific uses from the annual reporting form is understandable given constraints of time and space and the planned collection of this information in future benchmark surveys. However, because of public interest in the extent and potential economic consequences of foreign investment in specific types of real estate, the benefit and cost should be weighed of providing annual estimates that may be used in economic analysis.

In addition, the issue of data reliability must be raised. As more detailed information is required, the possibility of inaccuracies increases--either from deliberate noncompliance or genuine error. The International Investment Survey Act of 1976 and the Agricultural Foreign Investment Disclosure Act of 1978 require considerably more information than previously, and the need for even more to provide complete information on real estate, suggests that attention be given to this issue.

A second reason for concern with reliability is the complexity of corporate structures which make it possible for foreign ownership to be missed, not because of a deliberate attempt to avoid, but because the corporate officer responsible does not realize the foreign ownership several stages back which requires him to file. Further, this same corporate structure complexity increases the difficulty for U.S. officials to insure compliance by any investors deliberately seeking to avoid filing because of laws making investment outside their own country illegal. (See Zagaris, this study, for a further discussion of this issue.)

A third issue which needs to be addressed when considering data adequacy is the lack of information on foreign purchase of homes and other small pieces of property for personal use. While the number of such purchases is very small relative to the whole at the present time, they are giving rise to concern in areas where they are concentrated. Further, they may increase in the future, and even if their total magnitude is too small to exert an impact on the macroeconomy, they may have significant impact on a local area. Thus, given the political concern expressed now, and the possibility of a real impact on the future, some attention should be given to the desirability of recording this information.

Thus, at the present time, data on foreign real estate investment is inadequate for statistical analysis of its macroeconomic effects, but collection of such data is now beginning under the International Investment Survey Act of 1976 and the Agricultural Foreign Investment Act of 1978. It is too early to judge the overall adequacy of this data for studying the macroeconomic effects. However, it does appear that the main data needs are being met with the exception of lack of data on acres and value of real estate by use on an annual basis and information on purchases for personal use.

CONCLUSION

Judgments concerning the adequacy of existing data and the need for new data ultimately rest upon the policy issues currently being raised and likely to be raised in the future. To the extent that those issues require quantitative analysis, reliable data collected at regular intervals over a period of time are essential.

The recent rise in foreign direct investment in the United States, plus the potential of substantial increases beyond that, has caused a new interest in such policy questions in the macroeconomic area as: does foreign investment replace domestic investment, does it increase domestic employment, raise prices, help the balance of payments, and raise interest rates? Yet answers to such questions are not easily obtained both because of the complexity of the underlying economic relationships involved and because of the inadequacy of the data for making the necessary empirical tests.

In the past 10 years there has been a substantial increase in interest in these questions among researchers. (See footnote 7.) Yet their work has been seriously hindered by the inadequacy of the data base. Congress, in implicit recognition of this problem for the United States, passed the International Investment Survey Act in 1976 and the Agricultural Foreign Investment Disclosure Act of 1978. The data being collected under the terms of these Acts represent a substantial improvement over previously existing data both in terms of items covered and reliability. Yet it is too early to fully evaluate this data's adequacy because they have not been compiled. Therefore, its scope and design for various research approaches cannot be studied and its reliability against other sources cannot be tested.

In general, however, the data being collected appears to be adequate for studying the macroeconomic policy issues raised by foreign investment in real estate with the following two exceptions. First although the five year benchmark survey is expected to carry a breakdown of acres and value of real estate (property, net of plant and equipment) by specific uses, the annual surveys, reported on the BE-15 form do not. Thus, information on foreign direct investment in specific types of real estate may not be available on an annual basis. While information on land held for agricultural purposes, including land held for forest and timber production, is available from the Agricultural Foreign Investment Disclosure Act, related data such as investment in farm improvements and equipment, exports and imports, and taxes paid are not being collected under the terms of this Act.

The second area of real estate data inadequacy is in land purchased for private purposes such as homes. While these currently represent a very small amount of the total number and dollar value of homes purchased

every year, and are also a small percent of the dollar value of foreign investment, such purchases are already giving rise to public concern in the areas in which they are concentrated. Further, the possibility that such purchases will increase in the future is good if political instability abroad continues to increase at a faster rate than within the U.S. and as knowledge of how to move across national boundaries increases.

In evaluating the desirability of increasing the data bases to include these items, it will be necessary to consider not just the higher cost involved but the decreased reliability which may arise as a result of the greater complexity of information asked and the wider scope of respondents surveyed. Further discussion with those involved with the data collection might help to clarify the intractability of these potential problems. However, ultimately it will be a matter of judgment involving the importance of the policy issues both now and in the future and the desirability of exploring the real estate issues separately, versus the higher cost and possible decreased reliability of the data being collected.

Chapter 16

TRANSNATIONAL CONVEYANCING AND DISCLOSURE OF OWNERSHIP

Barlow Burke, Jr.*

ABSTRACT

This paper reviews the organizational vehicles which might be used by the foreigner investing in real property in the United States; the vehicles discussed are land sale installment contracts, timber contracts, land trusts, general and limited partnerships, and corporations and close corporations.

The basis for this discussion is the state law pertaining to these vehicles, with special attention to the disclosure (of information about the vehicle) required by law to be made to state officials. For some types of investment vehicles, e.g., land trusts, the identity of those interested in the trust will be disclosed only if some special need is shown, such as the need to repair a building up to local housing code standards. Other investment vehicles typically and routinely reveal the identities of those holding major interests in the entity, but present other problems of accessibility. The filing of partnership and incorporation papers often involves the disclosure of information which reveal more about the interests and identity of partners than of shareholders. This disparity might influence an investor's choice of one vehicle or the other and a resulting policy question for the states is whether uniformity of information on the identity of the investors using one or the other vehicle might be achieved by a statute which had as its major aim the disclosure of the identity and type of interest of each investor and which also made the information accessible to the public at one location in each county or state.

A solution for these problems, in the author's view, lies in amending the existing state recording statutes. The amendments would provide for the recordation of documents showing the identities of parties interested in the several types of investment entities. Recording these would aid in solving conveyancing problems which may arise in future transactions involving the transfer of the real property which is the subject of the investment.

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Introduction

This paper first describes the principal types of devices by which non-resident aliens may invest in and hold title to U.S. real property without making full disclosure of their ownership. Second, it analyzes the regulatory patterns imposed on these devices. Third, it considers common problems and makes some recommendations for their solution.

The law of real property is in this country traditionally a matter of State law and it is with State law that this paper will deal. Under State law, a property can be held individually or in the name of one of several legal entities. An individual can acquire an interest in realty by a conveyance (taking a deed), contract (to take a deed later), or trust agreement. The entities involved can be either a corporation, a partnership, or joint venture, and then the entity can receive a deed, contract, trust, or lease as would an individual.

Three of these four types of ownership--by deed, contract, or trust--have common origins in English law that allow analysis according to whether one had nominal, legal title or beneficial, equitable title. Holders of the latter can by trust or contract enjoy the fruits of the property, and holders of the former (the deed or contract-holders and trustees) can administer the property for the benefit of the equitable title holders. Moreover, contracts and trusts have a common origin that illustrates the present tendency of our land transfer system to permit equitable interests and perhaps encourage secrecy. A short historical digression will illustrate the idea that equitable ownership has long been with us, and produces much the same problems today as then.

An Historical Note

In the later 1520's and 1530's, Henry VIII needed a lot of money and had very little to finance England's rise to the status of a world power. 1/ He also needed to quell dissent within the English Church after its break with Rome. Trying to achieve both ends, he had seized much church and monastic property, but revenue still was not coming into his treasury at the rate he desired. To increase the flow, he searched for other sources of funds. Parliament was loath to vote him more money and so he needed to build up his Parliamentary support. After trying to make a series of deals with the nobles and gentry (all of which failed), he turned his attention to the lawyers sitting in Parliament. There were two groups of these: one, the lawyers who appeared in the chancery courts, hearing cases over which the church had jurisdiction. They were styled cases in equity rather than law, and they were out of favor with the king. The second group of lawyers was comprised of those working in the common law courts; they needed work and were jealous of the corrective power which equity possessed over law.

1/ Much of the following history can be found in Plucknett, Concise History of the Common Law (1956).

Henry proceeded in 1534 to deal with the common law attorneys. He promised to take some types of jurisdiction away from equity and turn it over to the law courts, thus providing those who appear in the latter with more work. The legislative device to accomplish this was the Statute of Uses. Uses were passive trusts, created by equity courts to enable the nobility to avoid feudal dues and to assure continuity of management of estates--ofttimes entrusted to the clergy (who were subject to canon law, from which grew our systems of equity). The Statute provided that the title to any property subject to these uses was thereafter to vest in the beneficiary rather than the trustee. The latter had legal title (i.e., was nominally the owner) while the former had equitable title (i.e., the use and benefits of the property). The Statute consolidated these in the beneficiary by passing the legal title automatically into the beneficiary's hand by legislative fiat. As a result, the common-law lawyers could enforce these trust agreements in their courts and Henry could hold the estate holders to their feudal dues. It was a neat coalescing of lawyerly and royal interests and was enacted by Parliament in 1535.

The blending of legal and equitable title gave rise to the possibility that the law courts could enforce contracts for the sale of property that did not meet the formalities of the common law and, eventually, to the modern contract of sale for land, in which the vendor holds the legal title and the vendee the equitable one until the contract's provisions are met--at which time the vendee receives, through the Statute of Uses, both titles and can thereafter obtain a law judgment saying so. Conceptually, this is very neat, but what if no judgment is obtained? Then the contract could remain a secret but the transfer could be completed between the parties. Remember that the "shooting through" of legal title was automatic under the Statute; it did not stipulate that obtaining a judgment was necessary.

To remedy this situation, the Statute of Enrollments was passed. It provided that all transfers be made a matter of public record, i.e., be "enrolled" or disclosed on the records. This created a furor and wellnigh a revolt among the landed upper classes, and was quickly repealed. In the long run, therefore, the Statute of Uses, recognized in most American states, facilitated land transfers and left undisclosed transfers a possibility. Easy transfer (by contract) was a gain, but the possibility of increased secrecy came with it as a loss to make future transfers more difficult. To some degree today, ease of transferability is still achieved at the expense of full disclosure about who owns or utilizes our own realty, using the following types of contracts or more formalized entities.

Land Sale Contracts

One device for marketing farm real property has been the installment land sale contract. 2/ Traditionally such a contract gives the purchaser

2/ C. Berger, A. Axelrod, & Q. Johnstone, Land Transfer and Finance 171-72 (2d ed., 1977).

immediate possession of the property upon signing the contract. The purchase price is then paid in installments, generally monthly, in amounts sufficient to compensate the vendor for the value of the property and the right to possession during the executory period of the contract. 3/ In that interim, legal title stays in the vendor, often meaning that he can mortgage, encumber, suffer a judgment, become insolvent, or have the property liened on for unpaid Federal and State taxes; the purchaser can lose his contract rights to any one of these third-party claims. 4/ The contract, however, could be written to restrict the vendor's rights to deal further with the property. Although the traditional benefits to purchasers of such contracts (e.g., low or no down payments, no settlement costs) would not typically be of much interest to the nonresident alien investor, in many States such contracts and contracts of sale cannot be recorded so that the identity of the purchaser remains off the public record until the last payment is made and exchanged for a recordable deed. Even where the contract and contracts of sale generally are recordable, they must be accompanied by a written acknowledgment by the vendor and lacking this accompanying document, the recorder will not accept them. Thus an agreement not to acknowledge will keep the contract and its contents off-record 5/ while still giving the purchaser the appreciation in value built up during the executory period of the contract.

Output Contracts

The law holds no surprises for the farmer by providing that crops growing on real property may be sown annually or grow perennially and naturally. 6/ Annual crops were called emblements at common law--corn, wheat, rye, potatoes, and garden vegetables are examples. 7/ Produced once a year, they were the product of the labor and industry of the grower. Along with crops which grow each year without reseeding from perennial roots, 8/ they are considered part of the real property on which they grow until they are severed or harvested. 9/ A presumption arises that the person holding title to the land holds title to the crops until the contrary is proven. 10/ In a conveyance, he thus grants title to both realty and its crops unless he reserves the crops in the deed. 11/

3/ *Id.* at 164-65.
4/ *Id.* at 167-69.
5/ *Id.* at 522-23.
6/ Flying Diamond Corp. v. Rust, 551 P.2d 509, (Utah 1976).
7/ Finley v. McClure, 222 Kan. 637, 567 P.2d 851 (1977) (held that income from crops belongs to the life tenant rather than the remainderman of realty).
8/ Clarke v. Alstores Realty Corp., 11 Wash. App. 942, 527 P.2d 698 (1974).
9/ Schlichenmeyer v. Luithle, 221 N.W. 2d 77 (N.D., 1974); Venie v. South Central Enterprises, 401 S.W. 2d 495, (Mo. App., 1976).
10/ Cobb v. Hoskins, 554 S.W. 2d 886, (Ky. App., 1977); First National Bank of Mission v. Thomas, 402 S.W. 2d 890, (Tex., 1965).
11/ Schuler-Olsen Ranches, Inc., v. Garvin, 197 Neb. 762, 250 N.W. 2d 906 (1977); Groves v. Hands, 546 S.W. 2d 638 (Tex. Civ. App., 1976).

Such presumptions, however, arise to be rebutted in appropriate circumstances, as where a trespasser or possessor without title sows, cultivates and then harvests a crop on real property belonging to another. The title-holder may grant the realty to a purchaser who takes the unharvested crops with the deed, buy if the harvesting of the trespasser's crop precedes that grant, the trespasser takes the title to them, characterized after severance from the realty as personal property. 12/

This characterization of crops as personal property requires that labor and industry go into producing them--the trespasser does not, for example, take title to timber on another's land because normally he does not sow it 13/ --but labeling a crop as personal property 14/ may serve several purposes, two examples of which are useful here: (1) it may be sold without a written contract as required for sales of an interest in realty; 15/ a mortgage on it is not a lien on the land on which it is growing. 16/ Crops may be realty or personalty as circumstances warrant.

The presumptions and the personalty label are useful to indicate a truism in the law that title to the realty and a crop growing thereon may be split. One example of such dual ownership is another contract interest not in but related to real property, the output contract. This is an agreement by a property owner to sell timber or another crop growing on the land to another. Often the seed or seedlings for the crop are supplied by the purchaser to the vendor, who agrees to plant and cultivate them until the harvest; 17/ either party may reap the crop, for which the purchaser agrees to pay a stipulated price. 18/ The purchaser, being a food

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12/ Whitney v. Bails, 560 P.2d 1344 (Mont., 1977) (contract purchaser who defaulted in midst of growing season held entitled to crops); Mater v. Boese, 518 P.2d 482 (Kan., 1974), But see Fisher v. Stuckey, 201 Neb. 439, 267 N.W. 2d 768 (1978). (tenant planting crop with notice of lease termination during growing season not entitled to damages for crop plowed under by new tenant when lease required all extensions to be in writing.)

13/ Kester v. Amon, 81 Mont. 1, 261, P.288 (1927), cited in Whitney v. Bails, 560 P.2d 1344 (Mont., 1977).

14/ Cargill Inc. Commodity Marketing Division v. Hale, 537 S.W. 2d 667 (Mo. App., 1976).

15/ Packwood Elevator Co. v. Heirdorffer, 260 N.W. 2d 543 (Iowa, 1977).

16/ Bornstein v. Somerson, 341 S.2d 1043 (Fla. App., 1977), affirmed without opin., 348 S.2d 944 (1977) (held, citrus fruit crop constructively severed by mortgage or sale through remaining on trees). See generally 5 Am. L. Prop. § 19.16 (Casner ed., 1952).

17/ Stender v. Twin City Foods, 5 Wash. Ct. App., 809, 490 P.2d 1311 (1971), rev'd 82 Wash. 2d 250, 510 P.2d 221 (1973) (adverse weather conditions held sufficient excuse for not harvesting pea crop).

18/ Staggered planting and harvesting dates are often used. Id., 510 P.2d at 223. See also Fiel v. Handley 264 Md. 433, 287 A.2d 23 (1972) (held grower and packer had jointly to decide to terminate harvest).

processor or packer, typically controls the timing of the harvest. The purpose of such a clause is to control the arrival of the crop at the purchaser's plant. 19/

The land to which this type of contract applies usually is described in the contract just as it would be in a contract of sale or deed for the land--by metes and bounds or other standard boundary description--but always the acreage to be planted is included 20/ and is often essential to the description because the output is estimated according to the acreage planted or harvested.

In the case of circumstances resulting from adverse weather conditions, a break-down in mechanical harvesters or other delays in the harvest, so that the time of optimum maturity passes without a harvest, the harvestor will have the option to divert the crop for seed, feed, or other secondary usage for the crop, making some downward adjustment in the purchase price. 21/

Since such agreements deal with timber or a crop, rather than the land from which the crop springs, a dual ownership arises: the real property may still belong to the vendor and the crop to the purchaser. 22/ Particularly where the seed is supplied by the purchaser, the parties are generally thought to have created a bailment rather than a sale of the seed. 23/ Often this result is based on contract language expressly reserving title to the seed.

Where there is a right of entry in the purchaser to enter upon the property and cultivate or harvest the crop, that right may be the conveyance of an interest in real property and the contract as a whole becomes recordable. At the same time, the right of entry works a constructive severance of the crop so that it becomes personalty when the contract is executed. 24/

19/ Id., 510 P.2d at 223.

20/ Rudy-Patrick Co. v. Dela Costa Farming Co., 557 P.2d 869, 871 (Wash. Ct. App., 1976).

21/ Stender v. Twin City Foods, 2 Wash. 2d 250, 510 P.2d at 225 (1973). See also Naples Fruit & Vegetable Co. v. Townsend, 276 So. 2d 222, (Fla. 1973); Dorsey Bros. v. Anderson, 264 Md. 446, 287 A. 2d 230 (1972); Dopheide v. Schueppner, 163 N.W.2d 360, (Iowa, 1968).

22/ Barton v. Artery Company, Inc. 279 Md. 94, 367 A.2d 935 (1977); Barron v. Edwards, 45 Mich. App. 230, 206 N.W.2d 508 (1973) (sod held personalty); Groth v. Stillson, 20 Mich. App., 704, 174 N.W.2d 596 (1969) (Christmas trees held personalty).

23/ R. Brown, Personal Property 232 (3d ed., 1975) and cases cited therein; Rudy Patrick Co. v. Dela Costa Farming Co., 557 P.2d 869, 872, n.3 (Wash. Ct. App. 1976).

24/ But see Layman v. Ledgett, 16 Wash. App., 733, 558 P.2d 1378 (1977) (held no constructive severance of timber uncut at end of 40 year timbering right).

When the land or property owner later transfers the property after the output contract is signed and the conveyance contains no reservations or exceptions for the crop, the vendee of the property may assert that the crop was conveyed with the property. The vendee's notice of the contract severance of the crop from the real property will decide the case and no title to the crop will pass to him. 25/ The easiest method to provide a third-party vendee of the land with notice is by recording the contract, providing that where the crop has been harvested, the land beneath becomes alienable. 26/ Without such a provision, title problems may ensue, making this type of contract disadvantageous to property owners. Nevertheless, the purchaser of the output gains considerable control over land use without taking title and disclosing his identity on the land title records. When nonresident aliens utilize such contracts, they would be unlikely to require a right of entry and their interests likely would remain severed personalty under the recent case-law.

One type of output contract illustrating the uncertain state of the law involves timber. The interest transferred by such contracts is either a conveyance of an interest in the real estate on which the timber is located or a contract 27/ to permit someone to enter upon the land and cut the timber, but without transferring any interest in the underlying soil. 28/

The motive for transferring such interests using the language of conveyance is easily enough understood. Purchasers of these interests recognize that the timber represents the largest component of the fair market value of the land and to further the security and stability of the interest the document often refers to the interest as if an interest in realty were being transferred. 29/

But the motives of the woodsman aside, it makes little sense to speak of a freehold or nonfreehold interest in a timber harvest. A life estate in harvested timber makes little sense since once harvested it cannot be returned to the land for the benefit of reversioners and remaindermen. And, speaking of a leasehold of the timber makes little sense since, at the end of the leasehold, a similar problem exists. That term of the lease only serves, then, to define a period of time during which the "leasee" has the

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25/ Groth v. Stillson, 20 Mich. App. 704, 174 N.W.2d 596, 598 (1969).

26/ *Id.*, 174 N.E. 2d at 598.

27/ Layman v. Ledgett, 16 Wash. App. 733, 558 P.2d 1378 (1977) (held, a grant of a temporary right to enter, cut and remove all standing timber on land constituted conveyance of interest in land).

28/ M. & T. Timber Co. v. Hope Silver-Lead Mines, 91 Idaho 638, 428 P.2d 955 (1967) (held, reservation of timber in deed did not give title to timber to grantor, but rather a profit a prendre to remove timber); Fragee Lumber Co. v. Haden, 197 S.E. 2d 634 (W.Va., 1973) (held, instrument either contract of sale of timber or a timber lease).

29/ Luccock, *Timber Deeds--A Case for the Restatement of the Law of Property*, 20 Wash. L. Rev. 199, 199-200 (1945).

right to remove timber of a type specified in the document. 30/

No matter how the purchaser's interest in standing timber is denominated, what vendor and purchaser intend is to transfer a right to enter, cut, and carry off designated timber while the purchaser's right is outstanding. The trees left standing at the end of that period are the vendor's; 31/ indeed, every tree is his until purchaser removes it. 32/ What "reverts" to or "remains" for the vendor is the untouched timber. What passes to the purchaser is the right to control harvesting of merchantable timber 33/ during the time the agreement is in effect. 34/ This right of control, however, is a variable concept--being itself controlled by contract provisions on the description of the timber to be harvested, the methods of logging to be employed, the millsite, any relogging, and the duty to clean up the forest floor. 35/ These provisions condition and in some sense define the purchaser's control over removing the timber.

More generally, since while the harvesting of timber proceeds on the land, little else can go on, and it might be argued that no matter how the parties identify the interest transferred, it involves a transfer of possession, for so long as the harvest takes. 36/ In a large timber tract, not all the acreage can be harvested at once and this suggests that if an immediate right to harvest becomes the subject of litigation, courts would be more tempted to (but still should not) use the attributes of estates to describe the transferred interest than they would be if the timber at issue were located in remote acreage not subject to immediate cutting. 37/

With this caveat, however, it seems clear that the vendor of the timber has not transferred any part of his title; the soil is still his, and so are the trees, yet the latter is subject to the purchaser's right to remove designated timber by severing them from the soil.

30/ Id. at 200-201; see also, Johnson, Washington Timber Deals and Contracts, 32 Wash. L. Rev. 30, 37-40 (1957).

31/ Forbes v. Columbia Pulp & Paper Co., Inc., 340 So.2d 734, (Miss., 1976).

32/ Barry v. Bank of New Hampshire, 112 N.H. 226, 293 A.2d 755, app. after rem. 113 N.H. 158, 304 A.2d 879 (1972) (purchaser, under oral agreement, did not acquire rights until he entered on land and cut).

33/ Cochran v. Union Lumber Co., 26 Ca. App. 3d 423, 102. Ca. Rptr. 632 (1972) (merchantable timber construed).

34/ Johnson v. Layman, 1 Wash.App., 909, 465, P.2d 196 (1970) (held, unless "timber deed" is expressly perpetual as to the time for performance, a reasonable time is implied from the instrument's silence on this point).

35/ O'Connell & Murphy, Check List for Use in Drafting Timber-Sales Instrument, 36 Oreg. L. Rev. 270 (1957).

36/ Paullus v. Yarbrough, 347 P.2d 620, (Oreg., 1959) (held, right to remove timber was license coupled with an irrevocable interest subject to specific performance).

37/ Note, Specific Performance of a Contract to Sell Standing Timber for Immediate Severance, 17 Ky. L. J. 48 (1928).

Whether the right of appropriation is called real or personal property depends on the immediacy of the removal (as previously suggested) and the need to inform third parties of the purchaser's right. 38/ Before the timber is severed, its legal status as a fixture and real property and its changed nature once severed as personalty belies the true function of both appellations: namely, the facilitation of the vendor's power to alienate and the purchaser's security of ownership, respectively. Once this is recognized, timber deeds or contracts should be readily recordable as an interest in realty entitled to recording as a right of entry and appropriation in the purchaser. Other more formal language of grant and conveyance is beside the point and begs the central statutory question of whether third parties need to know of the transfer, both to prevent the vendor from mortgaging the timber or, worse, selling it twice and to protect the purchaser's right to remove now and for the future. Two ideas are involved here: (1) at the moment of the transfer, what is conveyed is part of the realty, and (2) on sale it becomes subject to a severance (by the purchaser) which binds the vendor, but not third parties and until they receive notice of the transfer through the recording acts, at which time the severance is accomplished even as to third parties. 39/ This notice can be given constructively by the act of recording the transfer document --hence, the doctrine of constructive notice works a constructive severance at the time of recording the purchaser's interest.

The Land Trust

A modern version of the Statute of Uses provides as follows:

> Every person who, by virtue of any transfer or devise, is entitled to the actual possession of real property, and the receipts or the rents and profits thereof, is deemed to have a legal estate therein, of the same quality, extent, and duration, and subject to the same conditions as his beneficial interest therein. 40/

In some States, the Statute of Uses is accepted as a matter of judicial opinion, not legislative enactment. 41/ This is the case in some of the original 13 states, where the common law of Great Britain was "received" 42/ as the law of the former colonies at the time the Republic was established. What such statutes and judicial holdings to the same effect

38/ Pegg v. Mid-State Development Corp., 164 Mont. 525, 529 P.2d 1399 (1974); Plew v. Colorado Lumber Products, 29 Colo. App., 557, 481 P.2d 127 (1970); Spencer v. Strange, 184 So. 2d 878, (Miss., 1966).
39/ Johnson, supra n. 30, at 44-45.
40/ Fla. Stat. Ann., § 698.09 (1963); see also, N.D. Cent. Code, 859-03-04 (1967) & Tex. Stat. Ann., art. 742b-5 (1948).
41/ French v. French, 3 N.H. 234 (1825).
42/ Kimball, The Legal System, 263-75 (1966).

do not expressly decide is whether they can be negated by contract language to the contrary, for too literal a reading might annul many nonpossessory contract rights.

The Trust Defined

This literalism would invalidate the land trust. This is a device for holding title to real property in which the legal title is held in the name of a trustee, whether or not denominated as such on the public records. The trustee appears as the grantee on a recorded deed, but his power to deal with the property is restricted by an unrecorded agreement to hold the title for the benefit of the beneficiary or beneficiaries, who have possession and the right under the agreement to control all the trustee's dealings concerning the title. 43/ Thus, two instruments--a recorded deed to the trustee and an unrecorded trust agreement--are the basics of the land trust.

The General Provisions of the Documents

The trust agreement usually is executed first. It defines the relationship between the trustee and the beneficiary or beneficiaries. It provides that the former is about to or will receive title to the trust property which the former will hold in trust for the latter. The beneficiary's interest is the power to (a) direct a conveyance of the title by the trustee, (b) manage the trust property, and (c) receive the income from the rental, mortgage, or sale of the property. This agreement also provides that each and every beneficiary's interest shall be personal property, freely assignable, devisable and inheritable, and that no beneficiary shall hold any legal or equitable title to the property. The trustee for his part undertakes to execute all conveyances of the fee simple or any lesser interest in the title at the direction of the beneficiaries or their designees for this purpose. A method for removing the trustee and appointing a successor is provided, as well as the trustee's right to resign and be reimbursed for advances made to defend the title. At the end of a fixed period of time, the trustee is directed to sell the property. The period fixed normally is 20 years. The agreement stipulates that it shall not be recorded, but, if it is, the notice provided by recording shall not reduce the trustee's powers or title.

In the deed (in trust), the beneficiaries convey the title to the trustee. This is generally the shorter of the two documents, since the deed's provisions, other than the granting clause, can only enumerate the trustee's one power--to deal with and convey the legal and equitable title at the direction of the beneficiaries. This enumeration is somewhat lengthy because, typically, the trustee's authority to deal with every type of conveyance, from a fee simple through all lesser interests encompassed by the fee, is recited. Perhaps this is done to make the

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43/ A sample form following this pattern is provided in Garrett, Land Trusts, 1955 U. Ill. L. F. 655, 673-80.

trustee's powers appear as substantial as possible to avoid the execution of his title by the Statute of Uses. Thereafter the deed recites the trustee's power to convey without requiring any purchaser to inquire into his identity, authority, powers, or the disposition of the proceeds; that the beneficiaries interest is personal property and each and every beneficiary is without legal or equitable title to the trust property. These provisions track statutes that authorize land trusts in several States.

Land Trust Antecedents

The origins of such arrangements lie in the use of the so-called Massachusetts business trust. This was an early form of commercial enterprise established by a trust agreement in which property was conveyed to trustees to be managed by them for the benefit of the holders of transferable interests issued by the trustees for a consideration. 44/ Students of corporations will recognize this as an early form of incorporation and indeed it was used before the era of general incorporation development. In this guise, it found its way west to Illinois, where it was used to finance land subdivision around Chicago. 45/ Used for such purposes it was much changed: the trustee did not carry on the enterprise, but merely held the title until the lender was paid for a lot by a developer, who then improved and sold it to a purchaser. As such, it became a financier's arrangement, with the advantage that both the lender and the developer could be beneficiaries of the trust; both were assigned rights--the lender a rate of interest and the developer a purchase right as well as the right first to improve and then sell the property. 46/ The flexibility of such devices has been appealing to both types of beneficiaries right down to the present day.

Advantages of the Device

Besides avoiding the applicability of the general incorporation laws and aiding subdivision development, the two-instrument land trust has other advantages: 48/

(1) It obviously allows beneficiaries to opt out of the publicity attending the recording of their interests; that is, it abets secrecy and privacy by assuring anonymity of ownership. This can, of course, be put to antisocial purposes (so can any such legal entity), but it also can encourage investment and allow large tracts of land to be assembled for develop-

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44/ State Street Tr. Comp. v. Hall, 311 Mass. 299, 41 N.E. 2d 30 (1942); Warren, Corporate Advantages Without Incorporation, 382 (1929).

45/ Schumann-Heink v. Folsom, 328 Ill. 321, 159 N.E. 250 (1927); Hart v. Seymour, 147 Ill. 598, 35 N.E. 246 (1893).

46/ Garrett, *supra* n. 43, at 656.

47/ Alexander, Subdivision Trusts: A Proposed Standard Form, 5 L. A. L. Rev. 487 (1972).

48/ Comment, A Device for Texas Land Development: The Illinois Land Trust, 10 Hous. L. Rev. 692, 693-96 (1973) (herein after cited as The Illinois Land Trust).

ment without fanfare. This, of course, assumes that an industrious title-searcher cannot infer the identity of the beneficiary who recently has executed the deed in trust; anonymity comes with time and the transference of the beneficial interest.

(2) Legal chaos in the lives of the beneficiaries (divorce, bankruptcy, insanity, sufferance of a judgment, etc.) will not complicate the title and the trustee can, under the deed and the agreement, still provide a purchaser with a good, marketable title. This is so because the settlor-beneficiaries of the trust suffer an equitable conversion at the time the trust is established and their interests are thereafter considered personal property--i.e., the right to receive the proceeds from the trustee's dealings with the title.

(3) After this equitable conversion, the beneficiary can remain in possession.

(4) Some inheritance taxes may be saved in some States since an endless succession of trustees can succeed one another as long as the trust remains intact and its purposes unfulfilled; the death of a nonresident beneficiary will not become an occasion for ancillary probate of his interest in the State in which the land is located, his interest being personalty and passing to a successor in interest under the trust agreement; inheritance taxes and probate fees may thus be saved. 49/

(5) Since the beneficiary's interest is personalty, common law dower rights arising in his widow do not attach to it and a spouse's signature need not be obtained for transferring it.

(6) In the 1920's, the land trust enjoyed a new use--to avoid the recently-enacted corporate income tax--that renewed interest in the device and saw it used in many jurisdictions besides Illinois where it first flourished. It remains true that the trustee neither reports income nor pays income taxes on the trust property; the beneficiaries do both. The land trust thus avoids double taxation.

Legislation Authorizing Land Trusts

Interest since the last-mentioned flowering has remained sporadic, but geographically spread widely around the country. Several States have enacted legislation to authorize use of the device. Florida enacted the most comprehensive statute in 1963. 50/ This statute provides that the interests of the beneficiaries shall be construed to be personalty if the parties so designate in the recorded deed. 51/ This would achieve

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49/ *But see* St. Charles Land Company-Achille Guibet v. St. Ament, 253 La. 243, 217 S.2d 385 (1969) (noted 15 Loy. (N.O.)L. Rev. 382 (1968).

50/ Fla. Stat. Ann., 8689.071 (1963); McKillop, *The Illinois Land Trust in Florida*, 13 U. Fla. L. Rev. 173 (1960).

51/ Fla. Stat. Ann., §8689.071 (4) (1963).

the second and third purposes of the trust at the expense of the first purpose of achieving anonymity of ownership, but this characterization leaves unanswered two more basic questions: (1) whether the Statute of Use applies to personalty, and (2) whether the trustee, with only the power to hold and convey the title, has been assigned sufficiently active duties to avoid the Statute altogether. On the first question, although there would seem to be no reason why the Statute should not apply to personalty, a majority of jurisdictions have held to the contrary. Professors Bogert and Scott, the two major treatise writers of the law of trusts, disagree on this point. It would seem that a trust without a purpose would not qualify as a trust at all, regardless of the Statute, but surely executed by the Statute if available in the jurisdiction. The crucial question, then, is not any analogy to the Statute, but the second one concerning the characterization of the duties assigned to the trustee. The Florida legislation and caselaw is silent on this question. What it does, in the main, is to provide the trustee with the power to convey good title by providing that a purchaser dealing with the trustee does not have the duty to investigate the identity of any trust beneficiaries, the trustee's authority to convey, the disposition of the purchaser's consideration or the provisions of an unrecorded trust agreement. 52/ Narrowing the purchaser's duty is for the purpose of enhancing the marketability and alienability of the title to the trust property.

North Dakota, in enacting legislation to authorize the use of land trust in that State, dealt with the issue (of the applicability of the Statute of Uses) which Florida ducked. It provided:

> No trust relating to real property shall fail nor shall any use relating to real property be defeated because no beneficiaries are specified by name in the recorded deed of conveyance to the trustee or because no duties are imposed upon the trustee, notwithstanding the provisions of (the state's Statute of Uses). 53/

This section additionally provides that a purchaser from the trustee need inquire neither into the right of the trustee to convey or into the disposition of the proceeds of the sale.

In both Florida and North Dakota, the beneficiaries, if dissatisfied with the trustee's dealings with the title, must look to the trustee personally rather than to the purchaser for satisfaction. The North Dakota statute, however, did not declare the beneficiary's interest to be personalty; indeed, it provides that the trust "relates" to realty and so may have given up some of its advantages in other jurisdictions. Moreover, it provides that no creditor's rights otherwise available against the trustee or a beneficiary shall be affected by the statute. 54/

52/ Fla. Stat. Ann., §8689.071 (2) - (3) (1963); Note, "Land Trust Act," 18 U. Miami L. Rev. 699 (1964).

53/ N.D. Cent. Code, §59-03-02 (Supp. 1967).

54/ Note, The North Dakota Land Trust, 45 N. Dak. L. Rev. 77 (1968).

Virginia has enacted legislation 55/ very similar to North Dakota's.

In the absence of statutory authorization, it has been argued that the passive nature of the land trust renders it an untenable entity for widespread use. Nevertheless, the secondary literature indicates an interest in the device and this must be symptomatic of some use.

Arizona, 56/ California, 57/ Indiana, 58/ Massachusetts, 59/ Kansas, 60/ Nebraska, 61/ New York 62/ and Texas 63/ have this type of interest or an interest in adopting it as a subdivision trust. Two commentators, in Virginia 64/ and Massachusetts, 65/ both note that the device appears to be little used so it would seem that, whether or not special statutory authorization is provided by the State legislature, a substantial case-law is needed to assure widespread use.

Land trusts have been reportedly used in Minnesota and Colorado as well, but probably the reason for the sporadic use is the continued legal and judicial uncertainties surrounding them. It is not the sort of device the conveyancing bar--a most cautious group in a profession where skepticism

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55/ Va. Code Ann., § 55-17.1 (Repl. vol. 1969): "No trust relating to real property shall fail nor shall any use relating to real estate be defeated because no beneficiaries are specified by name in the recorded deed of conveyance to the trustee or because no duties are imposed upon the trustee. The power conferred by any such instrument on a trustee to sell, lease, encumber, or otherwise dispose of property therein described shall be effective and no person dealing with the trustee shall be required to make further inquiry as to the right of such trustee to act nor shall he be required to inquire as to the disposition of any proceeds." The statute also provides that corporations' and creditors' rights are unaffected by the statute, as is the rule against perpetuities as well. See generally Arnston, The Virginia Land Trust--An Overlooked Title Holding Device for Investment, Business and Estate Planning Purposes, 30 Wash. & L. L. Rev. 73 (1973); Comment, Land Trusts in Virginia, 7 Wm. & M. L. Rev. 368 (1966).

56/ Carlock, The Sub-division Trust - A Useful Device in Real Estate Transactions, 5 Ariz. L. Rev. 1 (1963).

57/ DeWitt, The Illinois Land Trust - Its Undeveloped Potential in California, 41 L.A. Bar. Bull. 20 (1965).

58/ Note, The 'Illinois' Land Trust in Indiana, 3 Val. U. L. Rev. 298 (1969).

59/ Novak, The Land Trust as a Method of Finance in Massachusetts, 40 Mass. L. Q. 31 (1955).

60/ Comment, Land Trusts-Adaptability to Kansas Real Estate Practice, 14 U. Kan. L. Rev. 97 (1965).

61/ Note, The Illinois Land Trust and Nebraska Law, 47 Neb. L. Rev. 101 (1968).

62/ Note, Land Trusts in New York, 37 St. Johns L. Rev. 123 (1962).

63/ See The Illinois Law Trust, supra n. 48

64/ See Arnston, supra n.55 at 31.

65/ Novak, supra n. 59 at 31.

is endemic--would recommend to clients. In some States, moreover, the purposes for which a trust may be established are enumerated by statute 66/ and if the land trust does not fit one of these purposes, an abundance of caution is indicated, at least until other statutory vehicles are found. In Texas, as in most States, the purposes for which a trust may be established are not enumerated, 67/ but arguments made on the basis of other statutes seem attenuated and litigious. 68/

Case-Law

The best developed line of judicial cases on land trusts exists in Illinois, where an 1893 case involving property held under a trust, though not a land trust, indicated that the Statute of Uses was no bar in that jurisdiction to a trustee's holding the bare title without having further duties assigned to him. 69/ It was not until the 1920's that Illinois law fully recognized the land trust.

One issue arising shortly after the device was approved was the tort liability as between the trustee and the beneficiaries. What if an accident occurs on the property held under the trust agreement in a way so that the landowner would normally be liable? Who is responsible for compensating the victim of the accident--the trustee or the beneficiaries? Often this question is resolved in the trust agreement, which might typically provide that: a) the trustee is not responsible and the beneficiaries are; b) the trustee is responsible, or; c) the beneficiary is responsible and shall procure insurance, naming the trustee as the payee under the policy. Under the typical provisions of the land trust, the trustee does not have the right to possession and use of the property and since this is so, he has no fiduciary duties in this regard and anyway is in no position to control hazards on the land. 70/ But typically, too, he is the only party whose name will definitely be ascertainable from the public land records so some variant of "b" and "c" is incorporated into the trust agreement: the beneficiaries procure liability insurance in the trustee's name and the latter is initially responsible, but looks to the insurance and then the beneficiaries if the policy is not maintained, for the money to compensate injured persons.

If the trustee is given some use or possession of the trust property, he may be initially and ultimately liable, no matter whether insurance is procured by the beneficiaries. So if the trust agreement denies the

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66/ Newman, Trusts, 86-87 (1955).

67/ N.Y. Powers and Trusts L. 87-14 (1974): "An express trust may be created for any lawful purpose."

68/ See Comment, The Illinois Land Trust, supra n. 48 at 697-98.

69/ Hart v. Seymour, 147 Ill. 598, 35 N.E. 246 (1893).

70/ Garrett, supra, n. 43 at 664-666.

trustee use and possession, the beneficiaries had best furnish themselves and their trustee with some form of liability protection. 71/

Contractual liability arising in the course of dealing with the title is likewise usually governed by the documents. The deed in trust authorizes the trustee to deal with the title in many ways and, if in such dealings, the trustee is not liable on the contract of conveyance, no one is. So the beneficiary if injured by these dealings must look to the trustee for the breach of his fiduciary duty. 72/ There is symmetry here as well, for the trustee if forced to pay out can seek reimbursement from the beneficiaries.

Which brings this inquiry to a common focus: whether tort or contractual liability is involved, what is the relationship between the beneficiaries that indicates how much each should pay to satisfy their collective responsibility?

In defining the relationship between the trustee and the beneficiaries, the deed and trust agreement contains the full agreement between these parties so a court need not consider what other relationships might exist in law to give rise to the tort or contract liability of the beneficiaries once the trustee is clearly liable. The beneficiaries are not akin to corporate shareholders because they retain a right of control over the trust property as shareholders do not. Neither are they partners with the trustee because they have a right to transfer their beneficial interests freely. For this reason, the analogies of partnership and corporate law are not complete enough to apply to the trustee-beneficiary relationship in the land trust.

Among the beneficiaries themselves, however, how might their relationship be defined? Could they be considered, in the absence of some express agreement setting out the relationship among themselves, to be (say) partners or shareholders in a common enterprise? The prudently operated land trust will include a carefully drafted agreement defining this relationship over a whole range of topics. This is a third document necessary to the smooth operation of the trust and is separate and apart from the trust agreement. Among other things, it will provide a method for distributing the income from the property and this provision alone makes drafting the document worthwile.

71/ Brazowski v. Chicago Title and Trust Comp., 280 Ill. App. 293 (1975).

72/ If the beneficiary-trustee relationship were clearly one of agency, the incapacity or death of the beneficiary and perhaps even the transfer of his interest would terminate the agency and that is not the intent of the parties to the trust deed and agreement. Williams v. Inhabitants of Milton, 215 Mass. 1 (1913) (business trust held a true and valid trust); Robinson v. Chicago National Bank, 32 Ill. App. 2d 55, 176 N.E., 2d 659 (1961); Scott, 1 Trusts 74 (3d ed., 1967).

Partnerships may be written or oral; in fact, they may be extremely informal, depending on a common pattern of business conduct and a pooling of resources for its existence. Where the law of partnership attaches to a business enterprise, the Uniform Partnership Act applies in the absence of any agreement to the contrary. The Act has been adopted in all States and the District of Columbia to fill the silences where any written partnership agreement is incomplete or silent on partnership matters. 73/

It is unlikely that the beneficiaries would be found to be partners since a partnership requires an on-going business relationship for profit, 74/ and the uniform act "makes no mention of a partnership with freely transferable shares" 75/ as the land trust agreement typically provides for. Some cases have held that land trust beneficiaries are general partners because they retain a right of control over the trust property and thus are as much a partnership as Massachusetts business trustees, 76/ but the analogy is incomplete since the land trust beneficiaries can freely alienate their interests to a degree partners cannot without partitioning the partnership assets. Seldom would it be advantageous to permit the land trustee to convey a partitionable (real property) interest to the beneficiary. To do that would call into question the status of the beneficial interest as personal property; courts might hold that the right to convert personalty into realty renders it real estate, at which points the Statute of Uses would execute the trusts. 77/

There may, however, be instances of deadlock or impasse when the beneficiaries cannot agree on how to use the trust or how to direct the trustee to deal with the title--usually such dealings will be a conveyance of a lease or some other less-than-fee interest allowing productive use of the property. In such impasses, a court may be tempted to decree a sale of the trust property under the procedures of the Uniform Partnership Act. One Illinois court has refused to do this, but instead declared that it would decree a sale under the auspices of its general equity power. 78/

The State legislatures of Indiana and Illinois have asserted regulatory authority to compel disclosure of the beneficiaries under a land trust holding property whose condition violates a local health and safety ordinance or regulation. 79/ In Illinois, the disclosure is to be made to local enforcement officials, 80/ while in Indiana any person with a reasonable need may petition a State court to order the disclosure; 81/

73/ Hines, Agency and Partnership, 322 (1974).
74/ Harmon v. Martin, 395 Ill. 595, 71 N.E. 2d 74 (1947).
75/ State Street Trust Comp. v. Hall, 311 Mass. 299, 41 N.E. 2d 30 (1942).
76/ Marchulonis v. Adams, 97 W. Va. 517, 125 S.E. 340 (1924).
77/ Whitaker v. Schere, 313 Ill, 473, 145 N.E. 177 (1924).
78/ Regas v. Danigeles, 54 Ill. App. 2d 271, 213 N.E. 2d 730 (1964).
79/ Ind. Stat. Ann. § 30-4-4-4 (1978); Ill. Ann. Stat., § 80-81 (1978).
80/ Id.
81/ Ind. Stat. Ann. § 30-4-4-4(a) (1978).

where housing, health, or safety codes are being violated, the court must decree disclosure. 82/ The Illinois statute was enacted to deprive slumlords in Chicago of the benefits which derive from beneficiary's anonymity of ownership. 83/ On the trustee is imposed a duty to disclose the identity 10 days after he receives notice of the violation. 84/ The Indiana statute is somewhat broader and provides in part:

> Any person may petition the court for disclosure of information concerning beneficiaries or the trust estate. The court may order the disclosure of all or any part of the information requested in the petition only after the petitioner has shown both a reasonable need for it and that the trustee has either refused or neglected to provide the information on written request delivered to the trustee. 85/

There are, of course, many reasons why an individual beneficiary might want his trust interest to remain confidential. For example, the purchase may be one of a number of property acquisitions in the same neighborhood and in this situation the price of each piecemeal purchase might rise if the overall acquisition plan became public. The beneficiary might also wish to remove himself from complaining tenants or the negotiation of new leases.

Once statutes such as these are invoked, the trustee has, of course, no alternative but to comply because he may be subject to fine 86/ if he does not. The violation of statute at minimum renders the trust's provision for nondisclosure null and void and may terminate the trust altogether if it turns out that nondisclosure was the dominant reason for establishing the trust. 87/

82/ Id. §§ (b) (1) - (2).

83/ Ill. Stat. Ann. § 80-81 (1978), noted in Internal Revenue Rule 63-16--Effect on Nondisclosure of Land Trusts, 59 N.W. U.L. Rev. 98,99 (1964).

84/ Ill. Stat. Ann. § 80-81 (1978).

85/ Ind. Stat. Ann. § 30-4-4-4(a) (1978).

86/ E.g., Ill. Stat. Ann. § 80-82 (1978), provides for a fine of $100 per day.

87/ Perkins v. Hilton, 329 Mass. 291, 107 N.E. in 822 (1952) (where one takes a beneficial interest in trust because he would not be entitled to purchase the land himself the trust is unenforceable and illegal); Colonial Trust Co. v. Brown, 105 Conn. 261, 135 A. 555 (1926) (trust restrictions on duration of leases and size of buildings on downtown trust property illegal as detrimental to the community); In re Great Berlin Steamboat Company, 26 Ch. D.616 (1884) (attempt to give purchaser from trust apparent ownership to conceal identity of beneficiary is illegal). See generally, P. Haskell, Trusts 60 (1975) and cases cited therein.

> It is impossible to reduce a question of public policy to a formula. These questions, like so many other questions, frequently resolve themselves into questions of degree. Moreover, questions of public policy depend upon conceptions

Partnerships

The partnership is today a creature of statute, generally subject in most States to the strictures of uniform acts governing the establishment and operation of the entity. The acts are intended to provide a vehicle for solving common problems arising in many partnerships, including the problems of taking title to realty, the relationship among general partners and between general and limited partners in the limited partnership.

The partnership is one of the oldest and most widely used forms of business organization. Since World War II, it has in many years been the most widely used business entity (second only to corporations in many years). Well over 1 million have been in existence in each year since the mid-1960's.

General Partnerships

The Uniform Partnership Act (UPA) defines a general partnership as "an association of two or more persons to carry on as co-owners a business for profit. 88/ The UPA does not define a "partner" as such except as a member of this type of association and neither is an "association" defined, although prior common law referred to the partnership as if it were the aggregate of the partners, one of whom could be a natural person, a corporation, or another partnership, but who collectively did not comprise a separate legal entity. Only as the law followed mercantile custom did some cases, for some purposes, come to view the partnership as a distinct legal entity and at the time that the UPA was adopted, the advocates of the "legal entity" and the "aggregate" theories of partnership vied with each other to codify their theory in the Act. 89/

Partnerships of all types receive unique tax treatment as well. The partners, not the entity, both receive the tax benefits (accelerated depreciation, deductions for expenses, etc.) and pay any income tax due *pro rata*. The partnership reports its income, but pays no tax on it. This pass-through is the "conduit principle" of taxation applicable to partnerships, both general and limited.

> which are prevalent in the community at the time when the transaction takes place. Certain dispositions may be regarded as against public policy in all places and at all times. In most cases, however, conceptions of policy vary from place to place and from time to time.

A. Scott, *Trusts* § 62 at 155 (1960); *see* Restatement of Trusts, 2d, §§ 60, 62, 65.

88/ Uniform Partnership Act (UPA), 86.

89/ Crane, *The Uniform Partnership Act - A Criticism*, 28 Harv. L. R. 762 (1915); Lewis, *The Uniform Partnership Act - A Reply to Mr. Crane's Criticism*, 29 Harv. L. Rev. 158 (1915); Crane, *The Uniform Partnership Act and Legal Persons*, 29 Harv. L. Rev. 838 (1916); Hines, *Agency and Partnership* 318-319 (1974).

Limited Partnerships

The Uniform Limited Partnership Act (ULPA) initially was promulgated by the National Commission on Uniform State Laws around the same time as the Uniform Partnership Act. It was extensively revised in 1976 (the revision is hereafter referred to as RULPA). RULPA defines a limited partnership as "a partnership formed by 2 or more persons...and having one or more general partners and one or more limited partners." 90/ A general partner is defined only as one admitted to the partnership and named in its certificate as such, 91/ but in common parlance is a managing partner, responsible with any other general partners for the conduct of the partnership's business. A limited partner is defined as one admitted to the partnership and so named in its certificate. 92/ He has no responsibility for the debts of the business beyond the amount of his contribution to it, but he also lacks the power to act for the business. 93/ He surrenders management control in exchange for limited liability. This is a vehicle for investment if ever there was one--limited liability is achieved without incorporating and so incurring corporate income tax.

In the UPA the "aggregate" theory of partnership was preferred over the legal entity theory for two interesting reasons pertinent to this catalogue of investment vehicles. First, in the UPA "the law of agency shall apply under this act." 94/ That is, each partner in a general partnership acts as an agent for the business. The principal drafter thought that this provision would lead in time to the courts regarding the partnership as a separate legal entity for most purposes 95/ (i.e., incurring debts, suing, and being sued). Procedurally this meant that suit against one partner would, in effect, make the defendant implead the rest of the partners to defend the case.

Second and more importantly, the legal entity theory was thought to require a registration system for at least partnership names and in any more comprehensive system, the names of the partners, even undisclosed ones. Failure to comply would have to be policed and suits against an unregistered partnership could turn on pleading technicalities or even the question of the existence of an unregistered partnership. 96/ In nonlitigation contexts, registration of partnership might have spelled the end of the dormant or undisclosed partner, recognized at common law.

90/ RULPA § 8101(7) continues the definition in ULPA § 1.
91/ *Id.* § 101(5).
92/ *Id.* § 101(6).
93/ *Id.* § 303
94/ UPA § 4(3).
95/ Lewis, *The Uniform Partnership Act*, 24 Yale L. J. 617 (1915).
96/ Lewis, *supra* n.89 at 167.

These objections to the legal entity theory must be met in the ULPA because, if UPA general partnerships rely on the partners' capital and services to carry on its business, the ULPA limited partnerships are given only capital by its limited partners. For them, the limited partnership is nothing more than an investment entity. They need to know what they are investing in, so the creation of a limited partnership may be neither informal nor oral, as is the case in a general partnership. The requirements of the authorizing legislation must be observed in good faith and a partnership certificate 97/ filed in an office designated in the statute, usually the office of the county recorder of deeds. 98/ The certificate must disclose the firm name, nature of business, duration, location, the identity of all general and limited partners, the amount or nature of their contributions and share in the profits, 99/ and the procedures (if any) for personnel changes and continuance of the business.

"A limited partnership is formed at the time of filing the certificate in the office of the Secretary of State" 100/ or a later time specified on the certificate. This wording in RULPA reflects a major change in the prior uniform act. Along with a direct requirement of filing the certificate in the office of the Secretary of State in section 201(a) of the revised ULPA, it provides for a statewide central depository for all certificates of limited partnerships. Previously, a limited partnership doing business in several counties would have to file "with the clerk of the court" in each county. Nominally, it had only to file in the county in which it had its principal place of business, but prudent business practice dictated a wider filing. 101/ Nor did the former ULPA recognize the multistate limited partnership, though case-law often did so through choice of law rules; partnerships conducting an interstate business had to file wherever their business led them. The reason for the great concern about proper filing is that, if it is ever determined that the filing is insufficient, the partnership might lose its limited character and become a general partnership in the eyes of the law. The same threat hung over both intrastate and interstate limited partnerships in the ULPA. Article 9 of the RULPA provides for the registration of out-of-state limited partnerships and also resolves some choice of law problems.

Article 9 provides that the "foreign" limited partnership register with the Secretary of State before transacting business in the State by submitting a signed and sworn application for registration which must provide the same general information given on a certificate for a domestic limited partnership, 102/ including the names and addresses of all

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97/ RULPA § 210.

98/ State offices used for this filing are discussed in 8 Unif. L. Ann. 6 - 8 (1922 & Supp.).

99/ This is something not generally required of corporations.

100/ RULPA § 201(b).

101/ Crane and Bromberg, Partnerships 145-146 (1968).

102/ RULPA, § 902.

partners. 103/ If the requisite information is provided, a certificate to transact business over the length and breadth the State is issued. 104/

Considering the disclosure required of limited partners, but not required of general partnerships, the undisclosed investor may wish, in some instances, to run the risk of general liability and not become associated with a limited partnership at all.

Real property may form the "contribution" of limited partners at the inception of the partnership, 105/ but must as previously mentioned be reported on the partnership certificate. 106/ Property thereafter contributed (if not mentioned in the initial certificate) will be an occasion for amendment of the certificate. 107/ Likewise, a general partner may contribute real property to either a limited or general partnership.

The Effect of Filing

As to limited partnership:

> The fact that a certificate of limited partnership is on file in the office of the Secretary of State is constructive notice that the partnership is a limited partnership and that the persons designated therein as limited partners are limited partners, but is not constructive notice of any other fact. 108/

Presumably this means that a description of the nature of the business (e.g., holding raw land or realty development) or its capitalization cannot be taken to be as it appears on the face of the certificate. On the other hand, one who suffers a loss due to a false statement on the certificate of limited partnership has a claim for damages against the "person actually executing...the certificate who knew or should have known, the statement to be false..." 109/ Thus only founding and general partners may be liable for filing false certificates.

Taking Title

Partnerships initially had great difficulty fitting into the traditional rules for conveying real property. For example, at common law, title

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103/ *Id.* § 902(7).
104/ *Id.* § 903(a)(3); Note, *Foreign Limited Partnerships: A Proposed Amendment to the Uniform Limited Partnership Act*, 47 So. Cal. L. Rev. 1174, 1182-89 (1974).
105/ RULPA § (2); § 201(a)(5).
106/ *Id.* § 201(a)(5).
107/ *Id.* § 202(b)(1).
108/ *Id.* § 208
109/ *Id.*

could only be conveyed to natural persons so that one or more, and preferably all, the partners' names had to appear as grantees on the deed, perhaps along with tag-along words such as "partners" or the firm name. for the conveyance to be valid. 110/

So at common law, a conveyance from O, an owner, to the Widget Company was invalid. Under the UPA, the provision that...

> Any estate in real property may be acquired in the partnership name. Title so acquired can only be conveyed in the partnership name. 111/

...means as a practical matter that if in a conveyance from "O to the Widget Company," persons A, B, and C can establish that they are the partners in that company, the real property conveyed will be considered their partnership's asset. This they can do by parol or oral evidence or by showing a written agreement of partnership. 112/ If A, B, or C used partnership funds to acquire the title, the UPA establishes a presumption to aid this proof, that:

> Unless a contrary intention appears, property acquired with the partnership funds is partnership property. 113/

There were, of course, easier cases for the common law to decide. If the conveyance read "O to A and his heirs," and A is the same natural person, the common law requirement was satisfied. The words of inheritance---"and his heirs" in the conveyance were only intended to show that A took title in fee simple absolute; A's heirs took nothing and had no rights in the property generally at common law. If any or all of A's partners could later show that A acted for the partnership, A's title was held to be equitable or held in trust for the partnership. Even if A took title for a later-established partnership or was acquiring a title which was to be his contribution to the partnership's assets, he would hold equitable title if a contractual partnership agreement or a declaration of trust established this. 114/

110/ See discussion infra at n.119-120. Florida common law is summarized in Black, Problems of Title in Partnership Realty in Florida, 8 U. Fla. L. Rev. 255, 256-60 (1955).

111/ UPA § 8(3); Crane and Bromberg, Partnerships 289-90 (1968).

112/ UPA § 8(3); Robertson v. Baker, 11 Fla. 192 (1866); Barber v. Crowell, 55 Neb. 571, 75 N.W. 1109 (1898) (held a mortgage to a partnership in its fictitious name was effective as an equitable lien but not as a conveyance of title). See generally P. Basye, Clearing Land Titles, 660-61 (2d ed., 1971).

113/ UPA § 8(2).

114/ Barber v. Crowell, 55 Neb. 571, 75 N.W. 1109 (1898).

Another example will illustrate the further flexibility of common law. If a conveyance was from "O to A and Company," some common law courts held this conveyance valid, though only as to A who then held the equitable title to the property for the benefit of his partners in the company. 115/ Here, however, no words of inheritance appear, so the UPS's drafters worried that the grantee's (A's) title might be diminished by the omission (as would likely have been true). In consequence they provided:

> A conveyance to a partnership in the partnership name, though without words of inheritance, passes the entire estate of the grantor unless a contrary intent appears. 116/

So phrases like "and his heirs" or words of like import (i.e., code words for a fee simple absolute) are under the UPA not required to establish a fee simple conveyance to a partnership.

Indeed once the conveyance "O to A" is shown to mean "O to the partnership of A, B, and C" or whatever, 117/ the common law presumes that a joint tenancy was created. This meant that the concurrent ownership of the partners gave rise to a scheme of succession very different from heirship; at the death of one joint tenant, the other partners assumed control of his interest "by right of survivorship." The conveyance might infer a different result, as where the conveyance was to the partners and the spouses of each; so if the conveyance were "O to A and S_1, B and S_2, and C and S_3," the court might hold the spouses entitled to a right of survivorship of their spouses' partnership interest and this would mean that the partners would have to divide or partition the partnership asset after the death of any one partner. The partners A, B, and C were thus said to hold a tenancy in common, the legal name for concurrent ownership without the right of survivorship. Indeed in a common law conveyance from "O to A, B, and C," a tenancy in common will result today unless a partnership agreement exists and provides otherwise. 118/

115/ Hines, Agency and Partnership 375 (1974).

116/ UPA §8(4).

117/ If the showing is made by parol evidence, an ancillary problem is whether the Statute of Frauds requires a writing for the conveyance to the partnership to be valid. Crane & Bromberg, Partnerships 224-27 (1968).

118/ Depending on the use of such labels as joint tenancy or tenancy in common is risky, so partnership agreements often will spell out the right of survivorship in detailed terms. Often the death of a partner produced litigation between his heirs and next-of-kin; the former would argue the partnership interest was real property and the latter that it was personalty, by reason of its being converted into personalty in equity to facilitate disposition. Cultra v. Cultra, 188 Tenn. 506, 221 S.W. 2d 533 (1949), noted at 98 U. Pa. L. Rev. 269 (1949). In UPA jurisdictions, the concurrent rights of the partners were called a "tenancy in partnership," as if to upset existing common law presumptions. UPA § 25. In practice, the partnership agreement often gave surviving partners the right to buy out a deceased partner's interest.

No matter the provisions of the UPA, the common law of conveyancing dies hard. 119/ There is reluctance on the part of the conveyancing bar to take advantage of the UPA provisions. "Many conveyances are still made to some or all of the partners as individuals, with or without mention of the partnership. They thus needlessly preserve all the confusions and complications of the common law. 120/ One reason for this may be an initial suspicion between partners without extensive prior dealings. Taking title in more than one partner's name serves as a check on the dishonest partner because it means cosigners will be required to convey title away from the partnership, but, of course, the same risk exists in dealing with any partnership asset, e.g., its checking account, and the increased risk with realty is only a matter of degree.

These surviving common law formalities make disclosures of partners' identities somewhat easier, at the expense of rendering partnership transactions involving real property somewhat more cumbersome. The trend in the common law decisions and the UPA has been to ease the transaction costs at the expense of public record disclosure. Some States require that if a fictitious name is used in both general and limited partnership dealings, such as conveyancing, the identity of the partners must be disclosed in a partnership certificate filed with a State official. 121/

Giving Title

As a general matter, title abstractors and examiners as well as the conveyancing bar are going to want to see title given by a partnership in the same manner in which it was received. Seemingly accepting the "legal entity" theory of partnerships, the UPA's drafters provided that a partnership could take title to real property in the partnership's name and then conform to existing title practice by further providing "title so acquired can be conveyed only in the partnership name." 122/ A later conveyance from a partnership may, of course, be executed by only one partner. 123/ The UPA § 10(1) provides in this regard that any partner may convey in the partnership's name if the partner acts within the scope of his agency for the partnership and unless:

119/ UPA §10(5) does not help: "When the title to real property is in the names of all the partners, a conveyance executed by all the partners passess all their rights in such property."

120/ Crane & Bromberg, Partnerships, 223-224 (1968).

121/ Ill. Rev. Stat., c.96 § 4-7 (1971); Neb. Rev. Stat. § 67-101 (1971).

122/ UPA § 8(3); see also UPA § 10(5) for the analogous validation of a conveyance by all partners where title is held in all their names.

123/ UPA § 9(1): "Every partner is the agent of the partnership for the purpose of its business, and the act of every partner, including the execution in the partnership name of any instrument, for apparently carrying on in the usual way the business of the partnership of which he is a member binds the partnership..."

> ...the partner so acting has in fact no authority to act for the partnership in the particular matter, and the person with whom he is dealing has knowledge of the fact that he has no such authority. 124/

or unless:

> ...such property has been conveyed by the grantee or a person claiming through such grantee to a holder for value without knowledge that the partner, in making the conveyance, has exceeded his authority. 125/

Moreover, the executing or conveying partner can use his own name, the use of which passes the equitable interest of the partnership unless the first caveat previously quoted applies to the situation (no authority in fact and knowledge of this by the grantee). 126/ All this language is familiar to conveyancers because it resembles the provisions of the ubiquitous State recording acts for real property interests; 127/ a partnership conveyance is valid unless the grantee falls within a statutorily defined class of persons disabled from receiving a valid conveyance. Thus disabled is a grantee with "actual knowledge" or "knowledge of such other facts as in the circumstances shows bad faith." 128/ The grantee taking a valid conveyance is without such knowledge; he need do no more to validate his title, i.e., he need not record it, although perhaps the risk that the partner was acting dishonestly and will subsequently convey to a second grantee will encourage recording even though not requiring it. This pattern, with the same incentives to record, is similar to States with a notice-type recording act. 129/

Yet, the analogy to recording acts is hardly complete, for there is no recording of the partnership agreements that would provide "actual" or "circumstantial" knowledge in the way the recording of a conveyance will provide constructive notice of rights arising under it.

Where real property is held in the name of one or more of the partners without mention in the record title of the partnership, the record partner may convey in the partnership's name unless he has no authority in fact and the grantee knows this or unless the grantee or his assignee "is a holder for value, without knowledge." Here, again, an analysis by analogy to the recording acts is incomplete, for while the second provision operates like a notice-type recording statute, the first seems

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124/ UPA § 9(1).
125/ UPA § 10(1).
126/ UPA § 10(2).
127/ 4 Am. L. Prop. 535-545 (Casner ed. 1952).
128/ UPA §3(1).
129/ E.g., "No conveyance...shall be valid and effective against any person other than the grantor, his heirs and devisees, and persons having notice these of unless it is made by a deed recorded (with the provisions of the act)." Ind. Code § 32-1-2-11 (1972).

to require an examination of the partnership agreement to determine authority in fact.

In all these enumerated attempts to increase the alienability of partnership property in the UPA, the provisions of section 9(1) are incorporated by reference. 130/ Often the drafters of the UPA attempt to make plain which provision of § 9(1) is intended, but the general language of the incorporation makes the conveyancer with an abundance of caution wary, and so he will usually ask to see the partnership agreement to determine whether the partner conveying the property is acting within the scope of his authority. At minimum, he may ask for the grantor's warranty or an affidavit that he so acts. The conveyancer representing the partnership might argue that the overall purpose of these

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130/ UPA §§ 9(1) & 10 provide in their entirety:

§ 9(1) Every partner is an agent of the partnership for the purpose of its business, and the act of every partner, including the execution in the partnership name of any instrument, for apparently carrying on in the usual way the business of the partnership of which he is a member binds the partnership, unless the partner so acting has in fact no authority to act for the partnership in the particular matter, and the person with whom he is dealing has knowledge of the fact that he has no such authority.

§10(1) Where title to real property is in the partnership name, any partner may convey title to such property by a conveyance executed in the partnership name; but the partnership may recover such property _unless the partner's act binds the partnership under the provisions of paragraph (1) of §9_, or unless the property has been conveyed by the grantee or a person claiming through such grantee to a holder for value without knowledge that the partner, in making the conveyance, has exceeded his authority.

(2) Where title to real property is in the name of the partnership, a conveyance executed by a partner, in his own name, passes the equitable interest of the partnership, _provided the act is one within the authority of the partner under the provisions of paragraph (1) of §9._

(3) Where title to real property is in the name of one or more but not all the partners, and the record does not disclose the right of the partnership, the partners in whose name the title stands may convey title to such property, but the partnership may recover such property _if the partner's act does not bind the partnership under the provisions of paragraph (1) of §9_ unless the purchaser or his assignee is a holder, for value, without knowledge.

(4) Where the title to real property is in the name of one or more or all the partners, or in a third person in trust for the partnership, a conveyance executed by a partner in the partnership name, or in his own name, passes the equitable interest of the partnership, _provided the act is one within the authority of the partner under the provisions of paragraph (1) of §9_.

(5) Where the title to real property is in the names of all the partners, a conveyance executed by all the partners passes all their rights in such property. (Underscoring added.)

sections is to increase the alienability of partnership property by allowing one or more of the partners to transact business, including conveyances, for the business as a whole, but the question of what (if any) sort of title proof is necessary from the partnership as a legal entity remains unclear--perhaps at root because of the UPA's failure to choose between the two theories of partnership. 131/

Assigning the Partnership Interest

The preceeding two sections have discussed one or more partner's conveyance of the business' rights in real property. The problem was one of his authority to bind the business as a whole to the conveyance and the knowledge of the grantee concerning that authority. A second problem relates to a partner's transfer of *his* interest in the entire assets of the partnership or in some particular partnership asset. 132/

At common law, the questions arising on the transfer by a partner of his rights or the partnership assets came to the same thing in the end. A partner's share in partnership property was assignable, 133/ but the assignee took his rights subject to the preexisting equitable rights in the property to have it applied for partnership purposes. 134/ The assignment worked a dissolution of the partnership, however, by showing one partner's intent not to continue in it. So the business was dissolved by an assignment of even some of its assets. 135/

The UPA was premised on the need for greater stability of enterprise and so provided that:

> A partner's right in specific partnership property is not assignable except in connection with the assignment of rights of all the partners in the same property. 136/

In the same vein, i.e., to assure a continuity of business effort and enterprise, partnership property is "not subject to attachment and execution" 137/ by creditors of the partners contracting debts as individuals rather than in their partnership capacity; neither is partnership property subject to marital rights of a partner's surviving spouse; 138/ nor is it entitled the benefit of homestead exemption laws. 139/

131/ No provisions of the RULPA would affect the problems discussed in this section directly, and when the ULPA or RULPA applies to is silent on the question at hand, the provisions of the UPA are applicable as the more general statute.

132/ *See generally* Crane & Bromberg, Partnerships 235-40 (1968).

133/ *Id.* at 237, and cases cited therein.

134/ *Id.*

135/ *Id.*

136/ UPA § 25(2)(b).

137/ *Id.* § 25(2)(c).

138/ *Id.* § 25(2)(e).

139/ *Id.* § 25(2)(c).

Rather a partner's interest in the partnership in "his share of the profits and surplus," which the UPA drafters characterize as "personal property." 140/ This status of the share as personal property implies that the interest or share, as opposed to the right (say) to convey or possess specific partnership property, is freely assignable. 141/ The UPA provides that:

> (1) A conveyance by a partner of his interest in the partnership does not of itself dissolve the partnership, nor, as against the other partners in the absence of agreement, entitle the assignee, during the continuance of the partnership to interfere in the management of administration of the partnership business of affairs, or to require any information or account of partnership transactions, or to inspect the partnership books; but it merely entitles the assignee to receive in accordance with his contract the profits to which the assigning partner would otherwise be entitled.
> (2) In case of a dissolution of the partnership, the assignee is entitled to receive his assignor's interest and may require an account from the date only of the last account agreed to by all the partners. 142/

It is important in this statutory scheme to notice what can be assigned --only the "share of the profits or surplus." The UPA's policy is to give the assignee rights only in the amounts over and above what is needed for the overhead, business expenses, and capital costs of the business. Partnership costs and creditors must be paid before there is anything which each partner can assign. 143/ Thus, the partnership is preserved as a legal entity from the devastating legal effects of an assignment affecting partnership property and dissolving the partnership as it did at common law. It follows, too, from this policy of circumscribed assignability that the assignee of the partner has no right to manage, administer, or even monitor partnership business. He only has the right to receive the assigning partner's share of the profits or surplus.

This limited right in the assignee, as well as the denial of the right to monitor partnership business, should in practice give any assignee a feeling of insecurity about both what he is buying and what his relationship with the other partners will be. Assignment is, of course, one way of operating the partnership for the benefit of persons undisclosed in

140/ Id. § 25.

141/ Another way to say this is that the UPA destroyed the assignability of a share except for the partnership purposes. Lewis, The Uniform Partnership Act, 24 Yale L. J. 617, 634 (1915).

142/ UPA § 27.

143/ Some courts have ignored the literal provisions of the UPA where one partner has transferred his right in specific partnership property to another partner. Crane & Bromberg, Partnerships 238-39 (1968); see also UPA § 41(1), (2).

the partnership agreement, but whether assignees do in fact feel insecure and so pay less for the share, and whether undisclosed interests often exist, would seem to be open and uninvestigated questions. They may, in some instances, pay more to remain undisclosed.

Assigning the Limited Partnership Interest

Both before and after 1976 and the advent of the RULPA, a limited partner could assign his interest 144/ and his assignee became a substituted limited partner if the other partners consented to the assignment. 145/ The certificate after 1976 could negate this right and status. 146/ In either event, the certificate of limited partnership would have to be amended to disclose the identity of the assignee. 147/ This wider assignability and the concommitant right of the assignee to become a substitute limited partner (if he chose that status) and to inspect the books 148/ reflected the purpose of the limited partnership as an investment device.

The RULPA, as noted, continues this scheme, but with some modification designed to enhance the desirability of the limited partnership. It adds the provision that a limited partner ceases to be a partner after he assigns his whole interest. 149/ Also, for the assignee who becomes a limited partner, his liability has been limited. The revised act provides that, subject to the limited right of the partnership to recall distributions:

> ...the assignee is not liable for liabilities unknown to the assignee at the time he became a limited partner and which could not be ascertained from the certificate of limited partnership. 150/

Giving the assignee the election to become a substitute limited partner is wise from the point of view both of policy and the analysis of passive trusts under the Statute of Uses. If the partner-assignor lost his right to participate and his assignee had only the right to receive the share of surplus of the partnership, the Statute might arguably execute the assignor's interest. The 1976 RULPA is ambiguous on this point, providing:

> Except as provided in the partnership agreement a partner ceases to be a partner upon assignment of all his partnership interest. 151/

144/ ULPA § 18; RULPA § 702.
145/ UPA § 19(4); RULPA § 704.
146/ RULPA § 702; implicitly this was so in ULPA as well.
147/ UPA § 19(5), 25; RULPA is silent on this point, but amendment would still seem a prudent business practice.
148/ UPA § 19(3); RULPA § 305,704.
149/ RULPA § 702.
150/ RULPA § 704(b).
151/ *Id.* § 702.

The initial question would seem to be whether the Statute applies to a partnership interest, deemed personalty. As in the questions that arose in connection with land trusts, there is no reason why it should not. Assuming that it does and if the assignment is silent on what partnership rights rest thereafter with the assignee, the soundest rule of construction would be to vest the right to the interest and at least the right to monitor partnership transactions in the same person--i.e., the assignee. Where as may typically be the case, the assignment provides that the assignee may elect to assume the status of limited partner if all other partners consent, the right of election may itself be sufficient to move all title away from the assignor and activate the Statute, which will then execute the latter's title and pass it through the assignee. One of its original functions after all was to make clear the status of the title for revenue purposes and such ambiguous statutory provisions, which must constantly be read in light of off-record agreements to assign, means that this function is otherwise likely to remain unfulfilled. This is just the sort of legal enviroment in which the Statute was intended to operate.

Corporations

A corporation, when used as a vehicle for holding title, has several advantages, for by definition a corporation has a centralized management, perpetual life, a separate legal existence, and limited liability for its managers and shareholders. 152/ In addition, it is an easily utilized method of holding title, familiar to real estate professionals and the investment community alike. 153/ It is a well-known capital assembly device as well, and shares in it are freely transferable. 154/ Those shares are indisputably regarded as personal property. 155/ Likewise, the corporation is not subject to the legal uncertainties engendered by the split between the legal entity and aggregate theories of the partnership since the corporation is indisputably a separate legal entity. Yet there are disadvantages, too: the corporation is by the same token not the conduit for tax benefits and liabilities at the corporate level. 156/ If it is just used for holding land titles without more, a personal holding company 157/ and an accumulated earnings tax 158/ may be incurred as well.

152/ A.H. Frey, C. Morris, & J. Choper, Corporations 18-25 (1966).

153/ Stat. Abstract of the United States, No. 648 (1963) and subsequent replacement volumes.

154/ Free transferability of shares is not a necessary ingredient of a corporation and may be provided against. Sillman v. DuPont, 302 A.2d 327, (Dela. Super. Ct. 1970).

155/ Fletcher Cyclopedia Corporations 107-08, 132-34, (1974) and cases cited therein.

156/ Int. Rev. Code of 1954, § 11.

157/ Id. § 535.

158/ Id. § 541-47

Real estate investors have been loath to give up the advantages of partnerships--particularly the pass-through of tax benefits--and have sought to gain the advantages of both. The "close corporation" partially fills this bill of particulars. It has been variously defined. It has reletively few shareholders, holding shares not generally traded on the national securities or stock exchanges and considering themselves partners inter se. 159/ To facilitate this relationship, the shareholders have executed a written agreement whose provisions permit shareholder management of the business, 160/ distribution of profits as salary rather than dividends, 161/ protection of any employment contracts of shareholders with the corporation, 162/ dispute-settlement mechanisms, 163/ restrictions on transfers of shares, the valuation of shares to be transferred, and the selection procedures for future associates. All these provisions imply that investors in a close corporation are prepared to take an active part in the business.

Perhaps the general incorporation codes enacted by each State sub rosa provided incentives to use the close corporation, but since 1960, 164/ State legislatures have enacted various statutes tailored to the close corporation. Generally, these statutes blur the traditional corporate distinctions between the board of directors, management, and shareholders, as well as relax some of the initial organizational requirements for incorporation. 165/

159/ F.H. O'Neal, 1 Close Corporations § 1.02 (1971); see also 68th Street Apts., Inc. v. Lauricella, 142 N.J. Super. 546, 362 A. 2d 78 (1976) (opinion states that principals in a close corporation can be functionally viewed as partners with mutual rights and duties).

160/ O'Neal, supra n.159 at § 1.07; Note, Executive Compensation in Close Corporation: The Need for a Modified Judicial Approach to the Reasonableness Test, 1972 Duke L. J. 1251.

161/ For tax reasons, distribution of profits as salary rather than dividends will be beneficial to the close corporation.

162/ O'Neal, supra n. 159 at § 1.07.

163/ Note, Deadlock in a Close Corporation: A Suggestion for Protecting a Dissident, Co-Equal Shareholder, 1972 Duke L. J. 653. See also, Hetherington, The Minority's Duty of Loyalty in Close Corporation, 1972 Duke L. J. 921.

164/ O'Neal, supra n.159 § 1.14.

165/ Various State incorporation codes have lowered the minimun number of directors, authorized high quorum and voting requirements for both director and shareholder actions, and permitted such actions by unanimous written consent. "Other statutory provisions that may be useful in close corporations accomplish the following: ...sanction shareholder agreements which impinge upon powers traditionally within the province of the board of directors or otherwise depart in important respects from the traditional pattern of corporation management;...permit special contractural arrangements among the shareholders providing when and under what circumstances the corporation will be dissolved or setting up non-statutory dissolution procedure..." (Id. at § 1.14).

The most broadly permissive or "enabling" features of close corporate statutes are those authorizing agreements between shareholders to allocate management, profits, directorships, shares, voting rights and the right to hire and fire employees, among other things. 166/ Some of these enabling statutes permit such agreements only when all shareholders are parties, 167/ between a majority of shareholders, 168/ or among shareholders (presumably any two, a majority, plurality, or all shareholders). 169/

Sometimes such agreements must be embodied in the corporate charter 170/ or are enforceable only for a limited number of years. 171/ The tendency, however, seems to be to remove such restrictions. 172/ These agreements are most likely not to be matters of public record.

The Question of Business Purpose

Before the general incorporation acts were adopted in all States, a corporation had the power to acquire and hold such real property as was necessary and proper to carry out the purposes named in its charter. 173/ This power is codified in the incorporation acts. The Model Business Incorporation Acts empower a corporation to "purchase, take, receive, lease, or otherwise deal in and with real property..." 174/ Implicit in this authority is the proposition that a corporation may be established for the specific purpose of acquiring, holding and selling (i.e., investing in) real property. The ancillary powers of the incorporation codes may become a dominant corporate purpose as well, particularly where the code allows incorporation "for any lawful purpose," "for mutual profit and benefit not inconsistent with state law," "for purposes of trade," or "for any lawful business purposes." 175/

The last two statements of proper corporate purpose pose a problem, however, since "trade" or "business" must be defined to include the holding of real property for investment. 176/ It is possible to put

166/ Ill. Rev. Stat., c.32, § 1210-16 (1978 Supp.); Del. Code Ann., Tit. 8, § 350 (1967); Me. Rev. Stat. Ann., Tit. 13-A, § 618 (1973).
167/ Md. Ann. Code, art. 23, § 104(a) (1967).
168/ Del. Code Ann., Tit. 8, § 350 (1967); Cf., § 354 (1967).
169/ Fla. Stat. Ann. § 608.75(1).
170/ N.Y. Bus. Corp. L. § 620(b).
171/ Del. Code Am., Tit. 8, § 218(c) (10 years with renewal provision).
172/ O'Neal, supra n.159, at § 1.14(c)
173/ L. Friedman, History of Am. L. 447-59 (1973); 1 Fletcher Cyclopedia Corporations 423 (1974).
174/ Model Bus. Incorp. Act, § 4(d).
175/ 1 Fletcher Cyclopedia Corporations 424 (1974).
176/ Cotton, Restrictions upon Corporate Ownership of Real Property, 13 Mercer L. Rev. 1 (1961).

perjorative connotations on this activity, of course, labeling it "speculation" and a "passive investment." Indeed, one State, Texas, will not permit a corporation to hold land titles without undertaking further business activities like land development and subdivision. 177/

The tax consequence of a corporation's merely holding title may be that it would be treated as a collapsible corporation and for tax purposes the land would be a noncapital asset and taxed at the higher rates applicable on the sale or exchange of such an asset. 178/ There is a line of income tax cases which supports this treatment, but also a line which respects the corporate veil if a slight business purpose, such as the execution of leases and mortgages for the land, is achieved. 179/ What is clearly insufficient to establish a business or trade purpose under the tax laws is the carrying out of the procedures--adoption of bylaws, holding annual meetings, and electing officials--required for achieving incorporation, for these acts are preconditions to income-producing activities of any corporation. 180/

So tax and business considerations merge and blur the decision to incorporate activities relating to land title holding. Where the title holder is a nonresident alien investor, there may be further advantages in incorporating and thus having a local entity capable of acting for the investor/shareholders. To clear away the legal uncertainties inherent in "dummy" corporations, however, the corporate officials would have to have control and management powers with regard to the real property acquired by the corporation.

If the investors who become shareholders in such a corporation are a constantly changing group, however, incorporating may not be wise since each new investor/shareholder would have purchased shares with a new taxable basis attributable to their cost. 181/ This new basis is not attributable to the real estate, unless a liquidation of the asset follows close on the heels of the purchase. 182/ The last purchasers of shares must clearly intend to acquire their shares in order to liquidate the corporation. For investment purposes, the corporation is perhaps not the best vehicle for holding title.

177/ Tex. Rev. Civ. Stat., Art. 6138A (1970).

178/ Int. Rev. Code of 1954, § 1372(e)(5).

179/ Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943); Tomlinson v. Miles, 316 F.2d 710 (5th Cir. 1963); G. Lontrell Timanus, 32 T. C. 631 (1959).

180/ Shaw Construction Co. v. Commissioner, 35 T. C. 1102 (1961), aff'd. C. C. A. 9, 323 F.2d 316 (9th Cir. 1963).

181/ Int. Rev. Code of 1954, § 5, 1012.

182/ Kimbell-Diamond Milling Co. v. Commissioner, 14 T. C. 74 (1950), aff'd per curiam, 187 F.2d 718 (5th Cir. 1951).

Corporate Conveyances

Real property may be conveyed to a corporate grantee in the name of the corporation. 183/ A partnership or its own shareholders may transfer property to a corporation and that property becomes that of the corporation as distinct from the preexisting partnership or the shareholders since the capital assets of the corporation are its property, not that of the shareholders, who nonetheless may retain an equitable interest in it in that it is impressed with a trust to carry out the purposes of the corporation. 184/

Taking Corporate Title

A conveyance to a corporation can only be effective if the corporation is in existence. For the conveyances:

> ...the concept of a (corporate) 'legal entity' is a figure of speech. The question is not one of impossibility of transferring property to a void but involves the broader question of whether a transfer to or from an associated group is to be given its intended effect in the absence of compliance with incorporation formalities required by statute in order to entitle the group to corporate privileges. This may raise questions of intention and of policy but not questions of impossibility. A person may usually adopt any name he chooses and cause a conveyance to be made to himself in that name. Similarly there is no inherent impossibility in recognizing that a group of persons may associate themselves together and adopt an artificial or fictitious name for the group by which they may take title to property. Whether such a procedure contravenes any policy is entirely another question. 185/

The free use of fictitious names has a drawback, but it only arises when the fictitious group, perhaps intending later to incorporate, does not do so in fact, and later attempts to clear their title at a later sale. Then evidence as to the identity of the participants in the fictitious group and confirming conveyances to the grantee likely will be required by the grantee or his counsel to render title marketable. 186/ In the past, some States have passed statutes providing, in substance, that if real property is conveyed to a fictitious group later incorporated, the title to the realty vests in the corporation at the time it is

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183/ The corporate name must be reserved and registered with the Secretary of State or other official of the home State of the corporation. See Model Business Incorporation Act § 49; N.Y. Business Incorporation Law, § 402(a) (1963).

184/ 1 Fletcher Cyclopedia Corporations 132-45 (1974) and cases cited therein.

185/ P. Basye, Clearing Land Titles 630-31 (2d ed., 1971).

186/ Id. at 636-37.

effectively incorporated. The same type of curative legislation has also sometimes been enacted to cure defects in incorporation which might otherwise render title to or from the corporation unmarketable. 187/

While helpful to the conveyancer, such curative statutes may aid the investor who wishes to take title without disclosing the backers and operating structure of an after-established corporation for the time being. The quoted passage saved the question of whether disclosure before incorporation could be compelled by legislative acts as a matter of public policy. There seems little doubt that such a disclosure statute would be valid, but the use of fictitious names coupled with the curative effect of conveyancing legislation currently opens the door to considerable secrecy in corporate land title dealings.

The corporation must, of course, both take and give title through a duly empowered official so that his manner of executing the conveyance is "one running to the corporation by name or clear intendment" of the parties to the conveyance. 188/ This is not a matter of corporation law, but of ascertaining the intent of the parties and the identification of the corporate official as such on the conveyance. Use of the corporate seal, an affidavit that he acts for the corporation and not in his individual capacity have traditionally been used to indicate that the title is conveyed to or from the corporation. 189/ When the time comes to sell, as the corporation takes title, so must it deliver it to subsequent grantees. The acknowledgment of conveyances from the corporation cannot generally be acknowledged by shareholders, but may be by corporate officials. 190/

The evidence of intracorporate authority to transact business in the name of the corporation ordinarily will be furnished in a certificate from the secretary of the corporation showing both the agency and authority of the official. Sometimes the corporate charter or bylaw can perform the same function if the agency and authority are either express or inherent in the document. State bar association title standards often create a presumption of agency and authority when such certificates or documents are presented. 191/

The organizational structures previously discussed can be made more complicated in combination. Some examples will suffice to make this elementary point. (1) In some States, a corporation can become a partner in a general partnership. More importantly for its legal consequences, it can also in some States, become the general partner in a limited partnership. If it is the sole general partner, the liabilities of the partnership have been completely limited to the partnership business, giving it one more attribute of a distinct legal entity.

187/ *Id.* at 631-36.
188/ 1 Fletcher Cyclopedia Corporations 134 (1974).
189/ P. Basye, Clearing Land Titles 618-59 (2d ed., 1971).
190/ 1 Fletcher Cyclopedia Corporations 143, n.49 (1974).
191/ P. Basye, Clearing Land Titles 623-26 (2d ed., 1971).

(2) A trustee in a land trust is likely today to be a corporate trust company. (3) A partnership and a corporation might undertake a joint project and for that purpose create an entirely new entity, a joint venture.

In each example, the identity of the participants in any transactions with the title may be hidden and any later conveyances (e.g., where a corporate partner acts for the partnership in a joint venture property transaction) may involve several types of title proof.

Common Documentary Patterns

For each of the principal types of entities by which American real property is today allegedly held by foreigners, there is a common pattern of documentation. Two documents generally are involved. The first is either a deed to a land trustee, a certificate of limited partnership, or an incorporation certificate is a matter of public record. In contrast, the second is an off-record instrument--whether it be an agreement between the beneficiaries of the land trust among themselves or with the trustee, a limited partnership agreement, or an agreement governing the relationship among shareholders in a close corporation. It is the second, off-record document that often controls who has the authority to convey the real property and also reveals who the real parties interested in the property are.

Responding to the influx of foreign capital to purchase American real property, some jurisdictions, i.e., Iowa 192/ and Nebraska, 193/ have enacted statutes requiring nonresident, alien-owners of property to report their ownership to the State. It is perhaps too early to know if the reporting system and its penalties will be effective, but it is sure that the effectiveness of these statutes depends in large measure on the willing compliance of foreign owners and their local agents.

Supplementary patterns of response are foreseeable. One takes its cue from the statutes, in Illinois and Indiana, providing that a land trustee must, upon being served with a notice to do so, reveal the identities of the beneficiaries. 194/ Similar statutes could be devised to get at the identities of foreign owners utilizing trusts, partnerships, and close corporations. The mechanism triggering the notice would be

192/ Iowa Code Ann. § 567.9 (1975).
193/ Neb. Rev. Stat. § 76-1501-06 (1976).
194/ *See* text *supra*, at n.79.

a reasonable basis for belief that the reporting statute has been violated. 195/

Expanding the Purposes of the Recording Acts

However, other patterns of response involve a somewhat different mechanism altogether. For example, over the last 20 years, there has been a continuing debate over the purposes of the recording acts, which control the maintenance of the public records enrolling all or most interests affecting real property in each State. 196/ This debate has been most heated and vividly exemplified in the debate over statutes limiting the legal effectiveness of reverters and rights of reentry for a

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195/ Such a statute might provide:
If the Attorney General has reason to believe that any person is violating (the reporting statute), he shall file for record with the (Recorder of Deeds) in the county for which the property is located a notice of the pendancy of his investigation and of the fines incurred by violation of (the reporting statute). The entity owning such property affected by the notice shall have 3 months to bring itself into compliance or otherwise satisfy the Attorney General of its compliance.

196/ The following recording acts are typical:
North Carolina Stat. Ann. §47-18 (1959):
No (i) conveyance of land, or (ii) contract to convey, or (iii) option or (iv) lease of land for more than three years shall be valid to pass any property as against lien creditors or purchasers for a valuable consideration from the lienor, bargainor or lessor but from the time of registration thereof in the county where the land lies, or if the land is located in more than one county, then in each county where any portion of the land lies to be effective as to the land in that county.
Maryland Code, §3-202, 101, 203 (1974):
§101: No estate of inheritance or free hold, declaration or limitation of use, estate above seven years, or deed may pass or take effect unless the deed granting it is executed and recorded.
§202: If a grantee under an unrecorded deed is in possession of the land and his possession is inconsistent with the record title, his possession constitutes constructive notice of what an inquiry of the possessor would disclose as to the existence of the unrecorded deed.
§203: Every recorded deed or other instrument takes effect from its effective date as against the grantee of any deed executed and delivered subsequent to the effective date, unless the grantee of the subsequent deed has: (1) Accepted delivery of the deed or other instrument (i) In good faith, (ii) Without constructive notice under §3-202, and (iii) For a good and valuable consideration, and (iv) Recorded the deed first.
Virginia Code, §55-96,-101 (1954):
§96: Every such contract in writing, and every deed conveying any such estate or term, and every deed of gift, or deed of trust, or mortgage conveying real estate or goods and chattels and every such bill of sale or contract for the sale of goods and chattels, when the

condition broken to a span of 20 to 30 years, unless the interest is rerecorded during the last several years of its legal life. 197/

In cases involving the validity of these statutory limitations on future interests, the courts must define the purposes of the recording acts. 198/

Traditionally, they provide a method whereby persons with an interest in real property may give notice to others who may become interested in the same property of their preexisting interest. May the legislature expand on that purpose and require that all valid interests of a certain type must also be recently recorded? To validate the reverter acts is to permit the legislature to facilitate proof of title by requiring that all presently valid future interests of designated types must be filed in the recent public records and so limit the period of the title search which a purchaser concerned about their existence would have to undertake in the public land title records.

There is no doubt today of a State's constitutional power to require that many types of documents affecting title to real property be recorded:

> As it is indisputable that the general welfare of society is involved in the security of titles to real estate and in the public registry of such titles, it is obvious that the power to legislate as to such subjects inheres in the very nature of government. 199/

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possession is allowed to remain with the grantor, shall be void as to all purchasers for valuable consideration without notice not parties thereto and lien creditors, until and except from the time it is duly admitted to record in the county or corporation wherein the property embraced in such contract, deed or bill of sale may be, but the mere possession of real estate shall not of itself be notice to purchasers thereof for value of any interest or estate therein of the person in possession...

§101: When two or more writings embracing the same property are admitted to record in the same county or corporation on the same day, if the previous sections do not provide for the case, that which was first admitted to record shall have priority in respect to the property in such county or corporation.

197/ See, e.g., Ill. Rev. Stat., c.30, §37(e) (1972) (retroactive application to existing interests); Mass. Ann. L., c.184A §3, 5 (1969) (prospective only).

198/ Trustees of Schools v. Batdorf, 6 Ill. 2d 486, 130 N.E. 111 (1955), noted at 54 Mich. L. Rev. 863; 1956 U. Ill. L. Forum 297; Hiddleton v. Neb. Jewish Educ. Soc'y, 186 Neb. 786, 186 N.W. 2d 904 (1971); Town of Brookline v. Carey, 35 Mass. 424, 245 N.E. 2d 446 (1969).

199/ American Land Company v. Zeiss, 219 U.S. 47, 60 (1911) (held valid procedures for establishing titles after record office in San Francisco was destroyed by fire after the 1907 earthquake).

It may be that requiring the recording of documents ancillary to the title (e.g., the agreements between beneficiaries of a land trust, partners, or shareholders in a close corporation) "is incidental to preventing the perpetration of fraud upon subsequent purchasers or mortgagees in good faith." 200/ This function of recording, excerpted from a case which invalidated a statute barring enforcement of a reverter or right of reentry, states a too restrictive test for requiring recording of documents. Yet it justifies the recording of instruments which are ineffective to transfer title, but which still facilitate the proof of title attendant upon subsequent transfers.

The recording acts serve two purposes: they are protective of certain classes of purchasers and also provide penalities for those who do not record their purchases. 201/ Within the protective function, two subfunctions are discernable: (1) they give security of title to present holders of recorded interests and (2) assure their transferees of a marketable title. 202/ However, the acts perform this last function imperfectly because a purchaser achieving a marketable title is assured not so much of what he owns, but that any person not appearing to have an interest within the chain of title deeds leading to a purchaser in fact has no interest in the property. Given this imperfection, and after several decades of legislation enabling the recording, along with title transfer documents, of recitals of crucial off-record facts, powers of attorney, marriage and heirship, as well as affidavits concerning the identity of parties to the conveyance or in the chain of title, it is reasonable to amend a recording act to provide for the recordation of affidavits which indicate who holds an interest in the fee title as a measure to facilitate the next transfer of title and to protect the purchaser at that transfer. 203/ So the legal question is not just whether requiring the documents ancillary to a land trust, realty partnership, or close corporation holding an interest in real property will prevent a fraud on subsequent purchasers, but whether the legislature may also facilitate the transfer of title to these later purchasers by requiring the prior interests to be disclosed before the transfer so that the purchaser may ascertain who is bound by the transfer by a trustee, general partner, or close corporate official.

As previously noted, statutes have attempted to authorize the land trust in several States by declaring that a purchaser need not inquire into the authority of the trustee or the identity of the beneficiaries. 204/ Without such a statute, disclosure of the beneficiaries' identities would be necessary when the beneficiaries direct the trustee to sell the real property which is the subject of the trust. In attempting

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200/ Board of Education of Central Sch. Dist. No. 1 v. Miles, 15 N.Y. 2d 364, 207 N.E. 2d 181, 184 (1965).

201/ Johnson, The Purpose and Scope of Recording Statutes, 47 Ia. L. Rev. 231 (1962).

202/ *Id.*, at 237-244.

203/ P. Basye, Clearing Land Titles 115-173 (2d ed., 1970), collects the statutes.

204/ *See* text *supra* at n.50.

to encourage use of the land trust, then, the legislature has indeed simplified the proof of title necessary to sell trust property and has provided a shield for the beneficiaries' identities. To the extent the legislature provides such a shield, there remains the possibility that it can remove it and require disclosure. 205/

Where the proof of title would otherwise be expensive to a purchaser who must assure himself that land trust beneficiaries, limited partners, and close corporate shareholders are indeed bound by a conveyance made by their representative, a legislature could certainly balance the value of nondisclosure against the inconvenience and expense involved in that later purchaser's ascertaining the interested parties and conclude that the recording of a disclosure statement is required in order to facilitate the future marketability of the land. As was said of an Illinois reverter act:

> The statute reflects the General Assembly's appraisal of the actual economic significance of these interests, weighed against the inconvenience and expense caused by their continued existence for unlimited periods of time without regard to altered circumstances. 206/

Thus, the reasonableness, if found, of such statutes expands the purpose of the recording acts which can then be used to validate good, marketable titles <u>and</u> cure bad, unmarketable ones. 207/

The same confusion as to what extent the recording acts may be used as a title-clearing device also is present in the marketable title acts, the most ambitious pieces of legislation in use today in many States. 208/ These acts rather drastically alter the public recording acts by extinguishing most interests in land not part of record during a set number of years, commonly 40 years. 209/ Since rerecording is the usual means of preserving old interests otherwise extinguished, 210/ these acts contain elements of both statutes of limitations and a legislative judgment that old interests are either stale or of no value, considering the expense of locating their present holders. In this last, there is also the notion that the wrong sorts of people may locate the present

205/ <u>See</u>, <u>e.g.</u>, Dennan v. Searle, 149 Conn. 126, 176 A.2d 561 (1961) (making and accepting this argument as to acknowledgments and assertions of deeds to validate a curative statute).

206/ Trustees of Schools v. Batdorf, 6 Ill. 2d 486, 130 N.E. 2d Ill, 115 (1955).

207/ Cline v. Johnson County Bd. of Ed., Ky. 1977, 548 S.W. 2d 507; Annot., "Validity of Statute cancelling, destroying, nullifying, or limiting the enforcement of rights of reentry for condition broken or possibilities of reverter," 41 A. L. R. 2d 1384 (1954).

208/ Basye, <u>Trends and Progress--The Marketable Title Acts</u>, 47 Ia. L. Rev. 261, 264-67 (1962).

209/ A. Axelrod, C. Berger, & Q. Johnstone, Land Transfer and Finance 754 (2d ed., 1977).

210/ Model Marketable Title Act, § 4(a).

holders, buy up their interest, and hold the title for ransom by threatening suit. 211/

Moreover, since marketable title acts generally have made an exception for unrecorded interests held in possession for the statutory period, the dispositive element validating these acts is even harder to identify.

> They proceed on the theory that the economic advantages of being able to pass uncluttered title to land far outweigh any value which the outdated restrictions may have for the person in whose favor they operate. 212/

Of course, it may be preferable not just to construe the recording acts in this way, but to amend them so that they would not only provide for the recording of (typically) "any interests affecting real property," but "any document facilitating proof of title to real property." 213/ A further amendment might require a reference to the previously recorded interest in the facilitating document as well.

A requirement of disclosure of the alienage of record owners is a reasonable exercise of a State's police power. 214/ To come within the permissable ambit of plenary legislative authority granted under the police power, a statute must promote the health, safety, morals, and (in the broader definition of the power) general welfare of the persons within the jurisdiction. Of course, not every person "within the jurisdiction" need be physicially present within the borders of the State, but need only be subject to its laws. If an alien, say, who is a nonresident of a State were not subject to its laws, he could not be disabled from holding real property, as he is in many States. 215/ Yet, on the other hand, to hold real property within the boundaries of a State does not necessarily mean that one is fully subject to its laws. 216/ Further, it is necessary to find that the disclosure of nonresident alienage bears a reasonable relationship to the general welfare of the State; in

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211/ Storke v. Penn Mutual Life Insurance Comp., 30 Ill. 6, 61 N.E. 2d (1945).

212/ Wichelman v. Messner, 250 Minn. 88, 83 N.W. 2d 800 (1957).

213/ "Affidavits pertaining to land titles have, however, posed problems as to their recordability and admissibility in evidence. In a number of States, they may not be recorded so as to give actual or constructive notice of the allegations they contain; and they are considered hearsay, thus may not be admitted in evidence before courts." A. Axelrod, C. Berger, and Q. Johnstone, Land Transfer and Finance 653 (2d ed., 1977). But see Conn. Gen. Stat. Ann. 47 - 12a (Supp. 1977); Wis. State Ann. § 706.09 (Supp. 1976).

214/ Hiddleton v. Neb. Jewish Educ. Soc'y, 186 Neb. 786, 186 N.W. 2d 904, 907-08 (1971).

215/ Morrison, "Limitations on Alien Investment in American Real Estate," 60 Minn. L. Rev. 621, 623-29 (1976).

216/ Shaffer v. Heitner, 97 S. Ct. 2569 (1977); Pennoyer v. Neff, 95 U.S. 714 (1877).

this regard, one State has found that it is reasonable for its legislature to conclude that absentee ownership of real property is "potentially detrimental to the welfare of the community" and that nonresident aliens "are least likely to consider the welfare of the community." 217/ In addition, withheld information concerning nonresident alien investors may impede the flow of information to State and local tax assessors desirous of obtaining information about the income flow from a property.

Using the police power, State legislatures have constitutionally abolished interests in real property by statute: dower and curtesy are examples of interests which have all been handled in this way by the States. 218/ Yet, forfeiture of an interest is obviously much more drastic than merely requiring its disclosure. The statutes concerning the limitation on reverters are relevant here as well, for in addition to a periodic rerecording provision, these acts barred the affected interests 20 to 30 years after their creation if not rerecorded. 219/ Thus, these statutes not only expanded the scope of the recording acts, but also functioned as a statute of limitations as well, cutting off the right to enforce the interest after a certain time.

Two important aspects of the discussion up to this point are the common two-tier pattern of documentation for the investment entities discussed and the various pieces of remedial legislation designed to respond to the problem which the nondisclosure of the off-record document produces at a later transfer. The legislative remedy varies with the type of entity, but is unresponsive to a conveyancer's need to know that all

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217/ Lehndorff Geneva Inc. v. Warren, Wis., 1976, 246 N.W. 2d 815, 825 (applying a reasonable basis standard of review to a State law disqualifying nonresident aliens from owning land within the State). It may be that for purposes of constitutional law some stricter standard may be applied by the U.S. Supreme Court. Graham v. Richardson, 403 U.S. 365 (1971) (equal protection clause held to invalidate State conditioning welfare payments on citizenship or, if the payee is an alien, on a durational residency requirement). See also In re Griffiths, 413 U.S. 717 (held invalid citizenship requirements for alien's admission to the bar); Sugerman v. Dougall, 413 U.S. 634 (1973) (held prohibition on alien's holding State employment invalid). All of these cases deal with an entitlement to livelihood, while disclosure of identity of nonresident aliens' land-holdings is only regulatory of investments, so is far less likely to receive close judicial scrutiny on that ground alone.

See also, on due process standards, Asbury Hospital v. Cass County, 326 U.S. 207 (1945) (held prohibition by N. Dak. legislature on corporate farming valid).

218/ Ryan v. Ryan, 277 So.2d 266 (Fla. 1973); Silverman v. Jacobs, 259 Md. 1, 267 A.2d 209 (1970); Opinion of the Justice, 331 Mass. 786, 151 N.E. 2d 475 (1958) (abolition of dower and curtesy initiate).

219/ Cline v. Johnson County Bd. of Ed., 548 S.W. 2d 507 (Ky., 1977).

the parties interested in the land have foresworn any further interest in it. For example, in the case of the land trust legislation, to inform a purchaser that he need not investigate the identity of trust beneficiaries and may rely on the apparent authority of the trustee to sell, 220/ is not to say that some courts may conclude that this statutory freedom from making inquiry does not establish a right superior to such uninvestigated interests. Such statutes may be enough to avoid a forfeiture of the property but still subject its title to lengthy litigation and to a vendor's lien of some type. 221/ The legislature's hesitancy in only providing the purchaser with a freedom from inquiry when it could have decided he possessed a clear title superior to undisclosed interests is telling and provides some explanation why the statutes attempting to encourage the use of land trusts have not been noticeably successful in the three States having enacted them. Similarly, in the Uniform Partnership Act (UPA), the uneasy compromise between the aggregate and the legal theory of the partnership 222/ is one reason why conveyancers handling a grant out of a partnership do not rely on the UPA's provisions endorsing the legal entity theory of a partnership; 223/ when the entity conveys property as vendor, more documentation of the interests foresworn is customarily required by the purchaser.

The development of a short recordable form could alert later purchasers if entity interests affecting the property are held by trust beneficiaries, partners, or close corporate shareholders, and to define and limit the extent of the inquiry which a purchaser should undertake. These forms could be recorded either along with the deed to the entity or within a reasonable time of its recording and could be filled out in the alternative, to wit, that the parties authorize the trustee to convey the property or that this authority is subject to such directions and powers of attorney as they may later record. The need for such early warning of the need to inquire seems clearly in line with the interests of the conveyancing bar and may be particularly easy to justify under the police power in the case of aliens, over whom jurisdiction in a title clearing suit may be difficult to obtain. What is needed, however, is not just a method for specifically identifying alien ownership, but for facilitating all conveyances in which multiparty entities are vendors.

220/ See text supra, at n.50.

221/ For instance, even bona fide purchasers taking a conveyance from a land trust may be on notice that the beneficiaries wanted to be in receipt an income flow from the property if they did not authorize sale of it.

222/ See text supra at n.88.

223/ See text supra at n.119.

Conclusions

Two conclusory proposals now seem in order: (1) Because of the need to acquire the information on ownership necessary to clear title held by trusts, close corporations, and partnerships, the recording acts should be amended to make recordable, not only documents affecting interests in real property, but also

> documents facilitating the proof of title to such property...

Along with the amendment should go a delegation of power to the recorder or other administrative official to prescribe short forms containing ownership information on the identity, including the fact of alienage, of beneficial holders of interests in the three entities previously mentioned. These forms will have to reference the documents to which they refer and will have to be filed under the same plat, parcel number or the names of the grantee or record owner in the conveyancing document thus incorporated by reference. A copy of the short form should be forwarded to a State office charged with administering any statutes requiring nonresident aliens to report their ownership of real property within the jurisdiction. (2) Failure to file such a document should give rise to a presumption that:

> One year after the recording of the interest in real property held by the (trust, partnership, or close corporation), if no (short-form statement of identity) is filed, it shall be conclusively presumed that the record thereof is full notice of other interests, local and equitable, in the property and that the record owner may transfer the property without any fiduciary or personal liability to any and all holders of any prior legal or equitable interest arising under any off-record (land trust agreement, partnership agreement, or agreement between close corporate shareholders)...

By delaying the recording of the short-form statement of identity, no recording rights need be lost--indeed, no investment opportunity need be lost because the group of investors is not yet fully formed. The conclusive presumptions raised by the proposed statute will, however, provide considerable incentive for filing it since the penalty is a loss of control over the trustee, general partner, or corporate agent.

On both of these proposals, alienage information may be separately requested and isolated in documents because of the later difficulty in obtaining deeds of release, affidavits, and waivers of rights from foreign countries, in foreign languages, or in unfamiliar types of documents. When the problems of clearing a title are unique, the legislature should be able to deal separately with it well before it becomes a problem at a later transfer of title; indeed, it is the legislature's anticipation of future conveyancing problems that justifies the proposal.

Chapter 17

FEDERAL TAXES AND FOREIGN HELD REAL ESTATE

Marianne Burge*

INTRODUCTION

Purpose and Scope of Study

The purpose of this study is to review U.S. taxation of real estate owned in this nation by aliens and foreign corporations, in response to comments that our tax laws permit foreign investors to avoid taxes on real estate income and capital gains.

To assist the reader in forming a view on whether U.S. tax laws favor or disfavor foreign investors, the study compares and contrasts tax treatment of U.S. owners with that of foreign owners and highlights significant differences in our tax laws applying to foreign investors and U.S. investors, with special emphasis on capital gains taxes, taxation of lease rents, and estate and gift taxes.

To put U.S. taxation of such income into the context of the investor's overall tax, home-country taxation of U.S. real estate income and gains of investors from several foreign countries are reviewed and summarized.

With a view to determining whether U.S. tax laws follow generally accepted methods of allocating taxing rights between the country where the real property is located and the country of residence of the investor, U.S. tax laws affecting foreign investment in U.S. real estate are compared and contrasted with those of several foreign countries. This is an important consideration for U.S. legislators, since any new legislation which might be regarded by other countries as unreasonable or unusual extensions of U.S. taxing rights to residents of their countries could encourage other countries to extend their methods of taxation of similar income and gains realized by U.S. investors in those countries.

This study examines U.S. tax laws affecting the taxation of U.S. real estate owned, either directly or through a variety of legal entities, by foreign nationals. The topics covered include complex technical

*/ Price Waterhouse & Co., New York.

concepts of U.S. tax and international tax laws and practices, and although the principal methods of ownership and disposition of U.S. real estate are discussed, the study does not purport to include every possible ownership structure or possible tax-planning technique which might be available in particular circumstances. Appendix II contains a discussion of the use of tax returns as a foreign investor data source. It is hoped that our approach makes the concepts comprehensive to the general reader. Technical terminology and citations have been kept to a minimum.

Recent Legislation and Studies

In recent years, it has been observed by U.S. commentators in the press and in government that there has been an increase in investment by foreign nationals in U.S. real estate, including farmland. A number of large acquisitions have been publicized in the press, such as the purchase of Kiawah Island off the coast of South Carolina by investors from Kuwait. More recently, U.S. farmers have commented in public that the purchase of U.S. farmland by foreigners is driving up the price of agricultural land. In an interview of U.S. farmers on the CBS television program "60 Minutes", it was said that U.S. tax laws favor foreign investors over U.S. citizens who buy and operate U.S. farmland.

Two difficulties face Federal and State Governments in evaluating such comments. One difficulty is determining the magnitude of foreign investment in U.S. real estate because of the absence of any centralized registration of landownership. The Agricultural Foreign Investment Disclosure Act of 1978 aims to deal with this problem with respect to agricultural land. This Act, under which regulations were issued recently, is one of several actions directed by the Federal Government in recent years in conjunction with other studies and surveys seeking to determine with greater accuracy the amount and nature of foreign investment in the United States in general, i.e., not only real estate. These include:

1. The Foreign Investment Study Act of 1974, which required a study by the Departments of Commerce and the Treasury of foreign direct and portfolio investment in the United States.

2. The International Investment Survey Act of 1976, which strengthened the Federal Government's data-collection activities regarding foreign investment and mandated a study to determine the feasibility of establishing a system to monitor foreign direct investment in agricultural, rural, and urban property.

3. The establishment of the Committee on Foreign Investment in the United States to review major foreign investments and advise the President on significant policy issues, which resulted in the establishment of the Office of Foreign Investment in the United States by the Department of Commerce in July 1975.

Even if the magnitude of foreign investments could be estimated, a second difficulty arises in determining the reasons which influence foreign nationals to invest in U.S. real estate. Some of the reasons why U.S. real estate is attractive to foreign investors include the political and economic stability of the United States, which encourages foreign nationals to buy personal residences here, the productive quality of U.S. real estate, the relative prices of U.S. and foreign real estate, which also are affected by currency parities, e.g., the fall in the value of the dollar in recent years, and tax advantages available in connection with real estate investment in general.

Concern over the greater U.S. tax advantages which it is claimed are available to foreign investors in particular prompted Congress in 1978 to request a study and analysis by the Treasury Department of the "appropriate tax treatment to be given to income derived from, or gain realized on, the sale of interests in U.S. property held by nonresident aliens or foreign corporations." 1/ A report on this study, which was mandated by the Revenue Act of 1978, was issued on May 4, 1979. 2/ The provision was adopted by the Congress as a compromise in the conference stage, in favor of a legislative proposal to tax the gains on sale of U.S. farmland. Since the Treasury study parallels the present study, it may be helpful to quote in full the Senate explanation for the enactment of the 1978 legislation:

> Section 553. Study of Taxation of Nonresident Aliens' Real Estate Transactions in the United States.
>
> (Senate Explanation)
>
> Present law - Under the Code, nonresident aliens and foreign corporations, not actively engaged in the real estate business in the United States, are subject to a flat 30 percent tax on their gross current income from U.S. real estate investments, but they are exempt from capital gains tax on the sale of capital assets generally, and U.S. real estate in particular. They may elect, however, to be taxed on their current income from real estate in the same manner as U.S. persons but, as a condition, must agree to be taxable on any gains from sale of that real estate.
>
> Foreign investors can generally avoid most or all U.S. taxes on U.S. real estate by utilizing U.S. tax treaties. . .
>
> Reasons for change - The committee believes it is necessary to review the application of U.S. tax laws and treaties

1/ Revenue Act of 1978, Sec. 553.
2/ Department of the Treasury, Taxation of Foreign Investment in U.S. Real Estate (May 1979).

to foreign investors in U.S. property to determine whether the present relatively favorable tax treatment afforded foreign investors should be modified.

Explanation of provision - The committee bill directs the Treasury Department to submit to Congress a study on the taxation of foreign owners of interests in U.S. property for the purpose of determining the appropriate treatment of the income or gain from these assets.

Effective date - The study is to be completed within six months of the date of enactment.

The concern expressed in the comment that foreign investors generally can avoid "most or all U.S. taxes" on real estate by using tax treaties already has prompted our tax-treaty negotiators at the Treasury Department to seek a provision in future income tax treaties that would permit us to tax capital gains on the sale of real estate owned through a U.S. or foreign corporation. Since tax treaties cannot impose taxation where none exists under internal law, this provision would come into effect only in the event that the United States changes its internal law to impose tax on such gains of foreign investors.

Extensions of U.S. taxing jurisdiction to tax capital gains of the foreign owners of U.S. capital assets already have been proposed in three congressional bills in 1979:

1. The Wallop Bill, which proposes to tax capital gains on the sale of U.S. farmland and rural land 3/;

2. The Grassley Bill, which is similar to the Wallop Bill 4/; and

3. The Bumpers Bill, which proposes to tax foreign investors on all capital assets located in the United States. 5/

3/ S.208, 96th Cong., 1st Sess. (1979), introduced by Sen. Malcolm Wallop.
4/ H.R. 3106, 96th Cong., 1st Sess. (1979), introduced by Rep. Charles Grassley.
5/ S. 192, 96th Cong., 1st Sess. (1979), introduced by Sen. Dale Bumpers.

SUMMARY OF CONCLUSIONS

A review of U.S. tax laws and tax treaties affecting real estate investment in this nation by foreign nationals leads to the following conclusions:

1. U.S. tax laws traditionally have been and still are more favorable to U.S. investors than to foreign investors in U.S. real estate. This is due to the allowance of deductions for expenses related to owning real estate for personal or commercial use, and taxation of appreciation at lower capital gains rates.

2. The U.S. lessor of real estate on a commercial basis normally arranges his operations in such a way that little or no U.S. tax is paid on rental income, and gains are realized in the form of lower taxes on capital gains. Each successive buyer obtains a new tax basis for future deductions.

3. There are a number of ways in which the U.S. owner of real estate held for personal use can defer or escape the capital gains tax altogether, reflecting our traditional policy of encouraging homeownership. Tax is deferred by "rolling over" personal residences and is avoided by sale after a certain age or transfer at death (until 1980).

4. The favorable U.S. tax laws affecting real estate provide the U.S. owner of real estate with both a hedge against inflation and a "tax shelter" for other income by permitting the deduction of real estate expenses against other income.

5. U.S. taxation of farmland, timberland, citrus groves, and cattle-feeding operations traditionally has been extremely favorable, e.g., permitting acceleration of deductions, deferment of taxable income and taxation at capital gains rates. These benefits are available to full-time farmers and "absentee" farmers. The favorable taxation of these agricultural activities has encouraged "absentee" U.S. investors to make investments of this kind as a "tax shelter" for other income.

6. The foreign investor is subject to the same U.S. tax provisions if he conducts an active real estate business in the United States, either directly or through a U.S. corporation.

7. If the foreign investor's U.S. investments are passive in nature, the U.S. tax is a high tax (30 percent) on <u>gross</u> rental income without deduction of any expenses, but capital gains from sale of the property are not taxed.

8. In the case of the passive investor, the 30-percent tax on gross rents can be reduced to regular U.S. tax rates on net income, as if the investor had an active U.S. business. A condition for this treatment is that capital gains are taxable in the year of sale.

9. A number of older U.S. tax treaties affect the foreign investor owning U.S. real estate through a foreign corporation. In this event, if the investment is passive in nature, the investor can elect to be taxed on net income at U.S. corporate tax rates and can eventually realize gains free of U.S. tax. To take advantage of such treaties, the investor must either be a resident of the treaty country or own the U.S. real property through a third-country corporation, with attendant complexities and costs.

10. The ownership of U.S. real estate through a corporation permits the foreign owner to dispose of the property without the imposition of U.S. tax on the capital gain. To escape the capital gains tax, the owner can sell the stock in the property-owning corporation or liquidate the corporation.

11. Other techniques include the sale of the property followed by liquidation of the corporation, a sale of the property for installment notes, and exchange of the property for like property.

12. The ownership of U.S. real estate through a foreign corporation permits its transfer by gift or at death without imposition of U.S. estate or gift tax. This may be a more important consideration for ownership of personal residences through a corporation than the capital gains tax. The foreign investor may, however, be subject to such taxes in his country of domicile.

13. Taxation of the foreign investor in his home country varies, depending on the country of his residence. Most industrial countries tax their residents on worldwide income and would thus tax U.S. rental income. Most countries would not tax income of a foreign corporation owned by a resident shareholder until such income is distributed as a dividend. Many industrialized countries, but not all, tax capital gains. In the countries we surveyed, it generally was possible to defer payment of foreign tax by investment through a foreign corporation.

14. A survey of countries in which a foreign national can own real estate indicates that real estate rents are taxed but that capital gains from the sale of the property almost always can be avoided by ownership through a foreign corporation.

TAX INCENTIVES FOR U.S. REAL ESTATE OWNERSHIP

To enable the reader to form a judgment of whether our tax laws favor foreign ownership of U.S. real estate, this section outlines U.S. policies on taxation of real estate in general, as evidenced by the tax incentives contained in the nation's tax laws.

U.S. tax laws have provided significant tax advantages for investment in real estate by U.S. citizens and business enterprises for many decades. Such incentives are basic to our tax laws and aim to encourage U.S. home-ownership, business expansion in general, and development of agricultural land and other natural resources. Some of these incentives may or may not be available to foreign investors, as discussed in subsequent sections of this study.

Deductions and Credits

Interest

All U.S. taxpayers can deduct interest on home mortgages and real property loans in general, regardless of whether the property is used for commercial operations, for capital investment or private purposes, or as a private home.

Real Estate Taxes

Real estate taxes also are deductible, regardless of whether the property is used for business or private purposes.

Depreciation

Real property (other than land) used in business or held for the production of investment income, can be depreciated for tax purposes on a straight-line basis over the useful life of the property. The useful life of a new building generally is presumed to be between 40 and 60 years, depending on the nature of the building. In the case of a new building, an accelerated method of depreciation (usually on a declining-balance basis) can be used. New residential property can be depreciated using an accelerated method of 200 percent of the straight-line rate and used residential property at 125 percent. Other new real property can be depreciated at 150 percent of the straight-line rate. For other used property, generally only the straight-line method is permitted. The various levels of rates of accelerated depreciation methods for real estate reflect changes made in tax legislation over recent years to limit the benefits from "tax shelters" in general, discussed further below. Under these developments, the excess of accelerated depreciation over straight-line depreciation has been treated as a tax preference subject to the minimum tax.

Capitalization of Development Costs

A taxpayer owning unimproved real estate, or real estate currently being developed, can elect to capitalize interest, taxes, carrying charges, and

development expenses, instead of deducting these expenses currently. This election can be beneficial if the real estate does not initially produce sufficient annual income to offset these expenses. Expenses capitalized in connection with developed real estate must be amortized over the useful life of property. Amounts capitalized increase the taxpayer's basis in the property for tax purposes and thus potentially reduce the amount of future gain on the sale of the property.

Investment Tax Credit

The investment tax credit (ITC), which allows taxpayers a credit against their income tax payable, generally is equal to 10 percent of the cost of qualifying tangible assets and, in effect, permits the taxpayer to deduct more than 100 percent of the cost of qualifying assets over their useful life.

Buildings and their structural components do not qualify for the ITC. However, there are some exceptions to this limitation--for example, elevators and escalators, and certain structures used for storage facilities are qualifying property for ITC purposes. In addition, the ITC is allowed for various assets connected with agricultural operations, discussed below.

Agricultural Activities

Farmers are permitted to use accounting methods which generally permit them to deduct expenses earlier than other types of business. Taxpayers who produce, buy, or sell merchandise must use the accrual method of accounting and account for the value of inventories on hand at yearend. Farmers may use the cash or accrual or hybrid methods of accounting, even though they have inventories on hand. This, in effect, delays the reporting of income with respect to inventories until such time as the goods are sold.

The option of the farmer to use the cash method can provide a tax benefit. For example, a farmer building a herd of cattle deducts the expenses of raising the cattle when paid and defers the reporting of income from sale until the cattle are sold. Similarly, a farmer can elect to deduct the cost of baby chicks, seeds, and young plants when purchased but need not report income from sale until the year of sale.

Although a farmer engaged in producing crops may be using the cash method of accounting, he can nevertheless elect to defer the deduction of expenses incurred in producing such crops until the year the gross income from the crops has been realized under the "crop method." A cash-basis investor in farms, orchards, and ranches also can elect to capitalize amounts expended to develop such properties before they become productive. A farmer has the option to deduct currently instead of capitalizing soil-and-water conservation costs, costs of clearing land, and costs of fertilizer.

The ability to accelerate deductions and to use favorable accounting methods has been restricted over the years to limit the use of investments in farms, citrus groves, and cattle-feeding ventures as tax shelters. Accordingly, some of these provisions are now limited. For example, the accrual method of accounting is required for large farm corporations, which must capitalize preproductive period expenses. Farming syndicates are required (1) to deduct feed, seed, fertilizer, or other similar farm supplies no earlier than the year in which such supplies are used or consumed (except in the event of a natural disaster); (2) to capitalize the cost of poultry; and (3) to capitalize expenses incurred to develop a grove, orchard, or vineyard prior to the year in which such properties become productive.

The investment tax credit applies to a variety of agricultural assets, including: investments in certain livestock, agricultural, and horticultural structures such as pigpens, chicken coops, greenhouses, and structures used for production of mushrooms, bulk storage of commodities, and property used for soil conservation.

Other Natural Resources

U.S. laws contain a number of incentives to encourage development of oil and gas, coal and domestic iron ore production, and other mineral production. In general, these are the deduction of certain capital expenditures incurred in developing the property, such as intangible drilling costs in developing oil and gas wells, mine exploration and development costs in the case of other minerals, and percentage depletion which allows a deduction for depletable assets measured as a percentage of income rather than as a percentage of cost of the property. Percentage depletion applies to a limited extent only to oil and gas wells, but continues to apply to other natural resources such as coal and domestic iron ore.

Taxation of Capital Gains

One of the principal tax incentives for the ownership of real estate is the fact that the expenses incurred, such as interest and real estate taxes for the private homeowner and depreciation for the business owner or lessor, are deductible from ordinary income, and the gains on sale of the property are taxed at lower capital gains rates, or are tax-deferred or even exempt in some cases. The principal provisions applicable to the taxation of gains from the sale of real estate are summarized below.

Long-Term Capital Gains

1. Long-term capital gains are taxed at a maximum rate of 28 percent, applicable to both corporations and individuals. There is a 12-month holding period for long-term treatment to apply.

2. In addition to the capital gains tax, a portion of the gain considered a tax-preference item may be subject to minimum tax or alternative minimum tax (individuals only).

3. For real property, to the extent gains reflect an excess of accelerated depreciation over straight-line depreciation, there is a "recapture" at ordinary tax rates in lieu of the 28-percent rate.

4. Individuals are exempt from tax on the sale of a principal residence, to the extent that the proceeds are reinvested in another principal residence within a certain period. This enables individual taxpayers to roll over their properties and postpone payment of tax on gains and possibly avoid such tax permanently (see 5 below).

5. Once an individual reaches the age of 55, he and his spouse can exclude $100,000 of capital gain on the sale of a principal residence. This provision was introduced in the Revenue Act of 1978.

6. Gains from exchange of real property for like property (i.e., other real property) are not recognized and any tax thereon is deferred.

7. Property can be transferred by an individual owner to a U.S. corporation controlled by him in exchange for that corporation's stock tax free, i.e., the tax on any appreciation is deferred. Similar deferral of tax on appreciated assets is available under a variety of reorganization provisions.

8. Until changes made by the Tax Reform Act of 1976, assets inherited from a decedent received a new current market value basis in the hands of the heir for future capital gains purposes. Thus, appreciation on property up to the date of death was not subject to capital gains tax. The 1976 legislation provided for a carryover basis on death, but this new rule has been so controversial that the implementation of the new carryover basis will not apply to deaths occurring before 1980. Their effect may even be delayed by further legislation.

9. Tax payment can be deferred to a later year if property is sold for an installment note. This allows the taxpayer to defer the tax on capital gains until a later year as the proceeds are received.

10. Although the sale of real property results in a lower tax on capital gains, the buyer of commercially used real property can depreciate the cost to reduce ordinary income.

Gains on the sale of real estate held as inventory for sale in the ordinary course of business are not entitled to the capital gains rates. For example, a construction company or individual who builds houses for sale is taxed on the net gain from the sale of the houses at ordinary income tax rates.

Capital Losses

Capital losses of a U.S. taxpayer generally are deductible only from capital gains. However, net losses from the sale of capital assets held for investment also can be deducted from the ordinary income of an individual taxpayer up to $3,000 annually, and excess losses can be carried forward to future years without limit until the loss is exhausted. A corporation normally can deduct capital losses only from capital gains, and excess capital losses of a corporation can be carried back 3 years then forward for 5 years. However, net losses from the sale of property used in a trade or business (known as Section 1231 assets) can be deducted as an ordinary loss from the taxpayer's income which is taxable at ordinary rates. This applies to both individuals and corporations and means that gains on the sale of business assets are taxed as capital gains, whereas losses are deductible as ordinary losses.

Agricultural Assets

As noted in the section on deductions and credits above, farmers are entitled to certain tax benefits. These include the characterization of certain sales as yielding capital gains rather than ordinary income, although development costs have been deducted currently. For example, if land is sold together with its unharvested crop, the gain therefrom will be considered a capital gain if the property was used in a trade or business and held for more than 1 year. Gain upon the sale of livestock (other than poultry) also is considered a capital gain if the animals were used for draft, breeding, dairy or sporting purposes and were held for 24 months or more, in the case of cattle and horses, or for 12 months or more in the case of other livestock.

Timberland

There are a number of provisions to allow the characterization of gain on timber sales as capital gains. A timber owner, or one with a contract right to cut timber, can elect that the cutting of the timber for sale or use in his trade or business will be considered a sale of the timber for a price equal to the fair market value of the timber on the first day of the taxable year in which the timber is cut. If such an election is made, the gain from the "sale" will be characterized as capital gain.

If the timber owner disposes of his timber pursuant to a contract under which he retains an economic interest in the timberland, such disposal will be considered a sale of the timber. The income from such sale is taxable at capital gain rates. A sale of standing timber under which the purchaser agrees to cut timber and pay a specified price for each unit cut is an example of a transaction which could qualify for such treatment.

Real Estate as a Tax Shelter

In the case of commercial real estate, the excess of expenses over rental income results in tax losses which can be used as an offset against the

taxpayer's other income. Gains on the sale of real estate and certain other real estate-connected assets such as timber are taxed at the lower long-term capital gains rates. The interplay of these two features has resulted in real estate being a tax shelter for U.S. taxpayers. Even in the case of personal residences, the ability to deduct the above-mentioned expenses against current ordinary income and to be taxed at capital gains rates on the sale of the asset have constituted a basic tax shelter for large numbers of ordinary people.

A further feature of a tax shelter is the ability to finance the investment with so-called "nonrecourse" loans, i.e., loans which are secured by the asset itself and not personally by the borrower. In the case of real estate owned for investment purposes, high leveraging through mortgage loans in conjunction with deductions for other carrying costs and depreciation generally results in tax losses for a number of years after acquisition. At the same time as tax losses are incurred, rental property throws off cash proceeds in excess of actual cash expenses. These features have made real estate investment attractive to U.S. investors for many years, although some restrictions, e.g., on the rates of accelerated depreciation, have been introduced in recent years as part of the attack on tax shelters generally.

The attractiveness of real estate as an investment by the ordinary U.S. homeowner probably is its most remarkable and, in the view of many, its most valuable feature. Although the taxation of sales of principal residences always has been attractive, the advantages are magnified in periods of high inflation. High inflation has had the effect of pushing individual taxpayers into higher tax brackets, which makes the deduction of mortgage interest a more important tax benefit. The ability to defer tax on capital gains when a home is replaced favors homeownership over other forms of investment. Thus, although certain tax shelters have been restricted substantially since the Tax Reform Act of 1976, real estate investments still have these recognized tax benefits for U.S. citizens.

U.S. TAXATION OF FOREIGN-OWNED REAL ESTATE

The deductions and preferential capital gains treatment discussed in the preceding section are available to all U.S. investors and to certain foreign investors, i.e., those who reside permanently in the United States or who are engaged in a U.S. "trade or business," or are treated as so engaged, as discussed below.

Taxation of Aliens and Foreign Corporations

U.S. taxation of aliens and foreign corporations depends on the classification of the taxpayer and the nature of the U.S. activities or investments which give rise to the income.

The fundamental distinction is between (1) nonresident aliens and foreign corporations on the one hand and (2) U.S. citizens, resident aliens, and U.S. corporations on the other. Nonresident aliens and foreign corporations are further classified into those who are engaged in an active trade or business in the United States and those who are in receipt of passive investment income.

U.S. taxation of these categories is summarized as follows:

1. U.S. citizens, resident aliens, and U.S. corporations are taxed on worldwide net taxable income at the regular individual and corporate tax rates applicable to income and at 28 percent on long-term capital gains.

2. Nonresident aliens and foreign corporations with an active U.S. trade or business are taxed on their net taxable income at the regular individual and corporate tax rates, including capital gains at 28 percent.

3. Nonresident aliens and foreign corporations with U.S. passive income are taxed at the flat rate of 30 percent on their gross U.S. income, collected by withholding at source, without any deductions. Capital gains on the disposal of a passive investment normally are not subject to tax.

4. Nonresident aliens and foreign corporations with U.S. passive income from real estate can make an election to be taxed on a net-income basis as if engaged in an active business, but as a condition for net-basis taxation, capital gains are taxed at 28 percent.

5. A similar election to be taxed on a net basis can be made on an annual basis by a foreign corporation incorporated in a country having an appropriate tax treaty or an individual resident in such a country. Because the election is on an annual basis, it need not be made in the year the capital asset giving rise to the passive income is sold, in which case capital gains would not be taxed in the year of sale.

U.S. Capital Gains Taxation of Foreign Investors

U.S. taxation of capital gains of foreign investors in real and personal property (such as shares in U.S. corporations) is limited in accordance

with generally recognized concepts of allocating taxing rights between the country of the investor and the country where the asset is located. In accordance with these concepts, the United States imposes its income tax on income earned from U.S. investments (e.g., dividends, interest, and rents) by foreign investors. However, the capital gain from the sale of the asset is not taxed in the United States (unless certain conditions exist) and the home country of the investor is recognized as having the prime right to tax such gains. If the foreign investor has closer connections with the country of investment, e.g., by physical presence or residence or conducting an active business there, the country may exercise greater taxing jurisdiction over the capital gains of the investor.

Thus, for example, in the reverse situation, if a U.S. investor sells his shares in a U.K. company to another U.S. investor, the U.S. taxes the gain by virtue of exercising jurisdiction over the investor (owner of the capital), while the United Kingdom does not tax the capital gain, even though the earnings of a U.K. company may have contributed to the appreciation of the shares.

The application of these provisions and concepts to foreign investment are discussed in detail below.

Taxation of Foreign-Owned Real Estate Income

The first major classification is between foreign corporations and foreign individuals.

The U.S. Internal Revenue Code classifies all foreign nationals as "aliens." Aliens are further classified as "resident aliens" and "nonresident aliens," with the following tax consequences:

Resident Aliens

A resident alien is, broadly, a foreign national who lives permanently or for an extended period in the United States and often possesses an immigrant visa. A resident alien is subject to U.S. tax in the same way as a U.S. citizen, i.e., on his worldwide income.

U.S. citizens, resident aliens, and U.S. corporations are subject to U.S. income taxes at regular individual or corporate tax rates on net income from rents after deducting all appropriate expenses, including interest, property taxes and, in case of commercial or leased property, depreciation, maintenance, and management fees.

Capital gains are subject to tax in the same way as those of a U.S. citizen during the period of residency. The alien could, however, give up his U.S. residency by relinquishing his immigrant or resident status and departing from the United States. He would then be classified as a nonresident alien and could make sales of U.S. property (including personal property such as shares) tax-free in some circumstances, as discussed below. He also could sell his U.S. property for an installment note, in which case he would not be taxed on the installments received as a nonresident alien.

Nonresident Aliens

A foreign national who is in the United States temporarily or not at all generally is classified as a nonresident alien. A nonresident alien is taxed on income from U.S. sources only (subject to some exceptions not relevant here).

Nonresident aliens and foreign corporations are taxed in one of two possible ways, depending on the method of operation of the real estate. The distinction to be made, both in the case of capital gains and rental income, is whether the property rental is received from a passive investment or from the active participation by the owner or his agent in the property's management, as discussed below.

Real Estate as an Active Business

Determination of an Active Business

A determination of whether an investment in U.S. real estate constitutes an active business or passive investment is based on concepts developed in case law, since the Internal Revenue Code and Regulations provide scant guidance.

Generally, one of the most important factors to consider is whether the foreign corporation (or individual) is carrying on management or other operating activities in the United States on a regular basis through dependent or independent management personnel or agents. This is illustrated by the following examples based on case law and business practice:

1. The purchase and sale of a piece of undeveloped land that was held as an investment would not be regarded as an active trade or business.

2. The purchase and development of land, e.g., by subdivision, building of roads, or similar activities, normally would be treated as an active trade or business.

3. Frequent purchases and sales of land could be regarded as land-dealing; an active trade or business possibly could be avoided by making each purchase through a separate corporation.

4. The receipt of rental income by a foreign owner of U.S. real estate gives the greatest difficulty in determining whether the rental is active business or passive income. The determination generally is made on the basis of whether there is active management by the owner or his agent. For example:

a. A foreign investor is not considered engaged in a U.S. trade or business if he leases the property to a single tenant on a "triple-net-lease" basis, under which the tenant pays real estate taxes, insurance, and general maintenance expenses directly.

b. A foreign investor generally is considered engaged in a U.S. trade or business if his agent actively manages rental properties and the property is not leased under a triple-net lease.

c. A house or condominium bought for personal use would not be regarded as an active business, even if it is rented occasionally.

Taxation of Rental Income

If the nonresident alien or foreign corporation is engaged in an active U.S. trade or business, the tax is imposed on the net rental income (after deducting expenses) at regular tax rates. The tax is imposed on income derived from or, as the Code terms it, "effectively connected with" the U.S. trade or business. In addition, if the foreign lessor is engaged in a U.S. trade or business in the year in which the property is sold, the capital gain also is taxed, unless one of the more sophisticated methods of disposition discussed below can be used.

Thus, as regards U.S. taxation of an active rental business by a foreign lessor, there is no significant difference between tax treatment of a U.S. lessor and foreign lessor, unless complex techniques for disposition of the property are used.

Real Estate as a Passive Investment

Taxation of Rental Income

A nonresident alien or foreign corporation receiving passive rental income from U.S. real property is subject to U.S. tax at a flat rate of 30 percent on gross rents. 6/ The tax is collected by the payor of the rents and withheld at source. 7/

Rents are included in a category of income termed in the Code as "fixed or determinable," which generally is considered to be the type of gross income which contains a large measure of net income, e.g., dividends, where only minor expenses are necessary to earn the income. Based on the normal net yield from rentals, a 30-percent tax on gross rents normally would exceed the regular U.S. tax rates on net income, and one might therefore question whether the 30-percent tax is indeed an income tax or in substance a tax partially on capital.

Taxation of Capital Gains

Passive Investment by Nonresident Aliens

Capital gains of nonresident aliens are exempt from U.S. tax in most cases, unless the nonresidents are engaged in a U.S. trade or business. The

6/ I.R.C. §§ 871(a), 881(a).
7/ I.R.C. §§ 1441, 1442.

taxation of capital gains differs considerably, depending on whether the investment is passive or active.

Capital gains of nonresident aliens with no U.S. business, i.e., passive investments, are taxed only if:

1. The aliens are present in the United States for a total of 183 days or more in the taxable year; and

2. The gain is from sources within the United States. 8/

If taxable, the gain is taxed at 30 percent on the net gain, i.e., reduced by capital losses allocable to U.S. sources. 9/ The tax rate of 30 percent is higher than the rate of 28 percent imposed on gains of U.S. citizens and resident aliens.

Capital gains from foreign sources are not subject to U.S. tax. The geographic source of capital gains is thus important in determining the taxability of nonresident aliens. The source of a gain depends on the nature of the asset. The source of a gain from the sale of personal property, e.g., shares in a U.S. or foreign corporation, is the country where the sale takes place, which for tax purposes normally is the place where title passes. Thus, if a Canadian sells shares of a U.S. corporation on the Toronto Stock Exchange, the gain would be foreign-source and exempt from U.S. tax.

The source of gains from the sale of real property is the country in which the property is located. 10/ Thus, if a Canadian investor sells U.S. real property, the gain is U.S.-source. However, as noted above, a U.S.-source gain is subject to U.S. tax only if the nonresident alien also spends 183 days or more in the United States in the taxable year of the sale. Even if a nonresident alien is present in the United States for this period, the specific provisions of a relevant income-tax treaty may exempt the alien from U.S. tax on capital gains. Tax treaties are discussed in detail below.

Nonresident Aliens in Active Business

If nonresident aliens are engaged in a U.S. trade or business, capital gains are subject to U.S. tax at 28 percent when they are derived from or "effectively connected with" such trade or business. 11/ If nonresident alien investors sell their U.S. real estate for an installment note, they normally would be exempt from U.S. tax on the proceeds received in the year after the sale, since they would no longer be engaged in an active business.

8/ I.R.C. § 871(a)(2).
9/ Id.
10/ I.R.C. §§ 861(a)(5), 862(a)(5).
11/ I.R.C. § 871(b)(1).

Taxation of Foreign Corporations

The taxation of rental income from U.S. assets of a foreign corporation broadly follows that applicable to nonresident aliens as regards the distinction between active and passive income. There is, however, no distinction between a resident or nonresident for corporations, nor any 183-day U.S. presence test.

A foreign corporation whose real estate activities in the United States constitute an active business is subject to U.S. tax on the net income from the business and on capital gains from sale of the asset at the same regular corporate tax rates as apply to a U.S. corporation. 12/

A foreign corporation is not subject to U.S. tax on capital gains unless the gain is derived from a U.S. trade or business. Thus, a foreign corporation with a passive investment in U.S. real estate is not subject to U.S. tax on gain from sale of the asset. However, as in the case of a nonresident alien, the passive rental income of a foreign corporation is subject to a 30-percent withholding tax on gross income. 13/

Election to Be Taxed on Net Income

If nonresident aliens own U.S. property as a passive investment, they are not subject to U.S. tax on the capital gain. However, the rental income would be subject to a 30-percent withholding tax on gross rentals, which--in view of the general net yield on real property--is, in effect, partially a tax on capital, as noted above.

The methods of taxation are thus very different, depending on the amount of the business activity in the United States, and the distinctions between passive and active investments often are difficult for the taxpayer to make with certainty.

Statutory Election to Be Taxed on Net Income

To reduce the U.S. tax burden on passive real estate investments and, in practice, to avoid the need for lessor and lessee to make a determination of whether the method of operation constitutes an active trade or business or passive investment, the Foreign Investors Tax Act of 1966 introduced an election which allows a foreign investor to elect to be taxed on U.S. real estate income as if he were engaged in a trade or business. 14/ If a foreign lessor is in fact engaged in a trade or business, he need not, and in principle cannot, make the election. However, if the investment is clearly passive, and in cases of doubt on this matter, the election is available.

12/ I.R.C. § 882(a)(1).
13/ I.R.C. §§ 881(a)(1), 1442.
14/ I.R.C. §§ 861(d), 882(d).

The election by the passive investor has the following U.S. tax consequences:

1. Rents are taxed on a net basis, after deduction of expenses, at ordinary U.S. corporate and individual rates.

2. Capital gains from the sale of the property are treated as "effectively connected" income and are subject to tax at regular capital gains rates of 28 percent.

3. The election once made is irrevocable without the consent of the Internal Revenue Service, which can be presumed to be difficult to obtain without a good business reason.

Consequently, the result of electing under the Internal Revenue Code to be taxed on a net-income basis on rents is that capital gains, which are exempt to a passive investor, are taxed because of the reasons stated above. Thus, the foreign owner of a passive investment in U.S. real estate must decide at an early stage whether to elect a net basis of taxation for rental income and thus subject any future capital gains to U.S. tax or to be taxed at 30 percent on gross rents and be exempt from capital gains tax.

As in the case of the nonresident alien, the Internal Revenue Code provides an election for the foreign corporation to be taxed on a net basis on its rental income as if it were engaged in an active U.S. business. As in the case of a nonresident alien, the condition under the statutory net-basis election is that the capital gain from sale of the property will be taxed. 15/ The election is similarly binding for subsequent years and cannot be revoked without Internal Revenue Service permission. The election results in the U.S. income being taxed as active business income and full taxation of capital gains.

Election Under Tax Treaties

The United States has in effect 26 bilateral income-tax treaties covering 48 countries, each concluded with a trading partner for the purposes of avoiding double taxation. A list of present treaties in force is included in Appendix I. Provisions in treaties which modify U.S. tax rates by reducing the amount of a tax (e.g., withholding tax), or the incidence of a tax, override the Internal Revenue Code. 16/

If the foreign investor is a resident of, or a corporation organized in, a country with which the United States has concluded an income-tax treaty, and the treaty provides for more favorable U.S. taxation of U.S. real estate income or gains, the treaty provision prevails. Treaty provisions vary, depending on circumstances in the countries and changing tax concepts over the years. Certain principles of allocating the taxing rights between countries of income crossing boundaries were developed and agreed upon by

15/ Treas. Reg. §§ 1.871-10(d)(2), 1.882-2(a).
16/ I.R.C. § 894.

the 23 countries comprising the Organization for Economic Cooperation and Development (OECD), in a sample tax treaty known as the OECD Model Convention. The U.S. Government's more specific negotiating position is contained in the Treasury Department's model income tax convention of May 17, 1977, known as the U.S. Model Convention. Appendix I contains a summary of the real estate provisions contained in U.S. treaties. Some of the major tax treaty provisions affecting real estate are as follows:

1. Real estate rental income can be taxed in the country of location. (This generally means only in the country of location, but the United States, for example, taxes its citizens and corporations on worldwide income, allowing a credit for foreign taxes.)

2. Real estate income often includes income from agriculture and forestry (e.g., U.S. Model Convention, Article 6).

3. Some older treaties limit the U.S. tax on real estate rentals to a maximum of 15 percent of gross rents (Canada, United Kingdom (1966 treaty), and Ireland).

4. Some treaties include an election for the taxpayer to be taxed on a net-income basis. This basis can be elected by the taxpayer on an annual basis (e.g., Canada, France, Germany, the 1948 Netherlands treaty, which was extended to the Netherlands Antilles, the 1945 U.K. treaty, which was extended to a number of U.K. territories, including the British Virgin Islands, and the 1966 United Kingdom treaty.

5. The newer treaties provide for a net taxation election on an irrevocable basis, as under U.S. internal law (e.g., U.S. Model Convention).

6. Capital gains from the sale of real estate are treated in various ways under present and model treaties. Generally, taxation is permitted in the country of location and thus in most cases U.S. internal law would in effect apply as discussed above. In other cases, gains from the sale of real estate are treated like other capital gains and are exempt from U.S. tax when realized by a resident of the other treaty country (Canada and the United Kingdom (1966)).

7. Many U.S. treaties provide that dividends and interest paid by a treaty country corporation to a foreign person are exempt from U.S. tax. A substantial part of an investment in U.S. real estate can be funded by a loan and the interest payments on such loan can be used by nonresident aliens to reduce U.S. taxation of their real estate income. The interest expense is deductible if the real estate investment is taxed on a net basis, and the interest payment is exempt from withholding.

For investors who are eligible to use a tax treaty, it may be possible to obtain a lower withholding tax on gross income or make an election for net-basis taxation under the relevant treaty. The advantage of the treaty election over the U.S. statutory election is that it can be made for any taxable year, and thus is not binding, as in the case of the statutory election. Accordingly, a foreign passive investor can elect to be taxed on a net basis until the year the property is sold. In the year of sale, the treaty

election to be taxed on a net basis is not made, and the capital gain from the sale of the property is tax-free. As noted, tax-free treatment applies only in the case of a passive investment, and the investor must ensure that the ownership meets this requirement.

The United States is in the process of renegotiating its older treaties. The new treaties can be expected to contain the following provisions along the lines of the U.S. model:

1. U.S. rental income from real property, including income from agriculture and forestry, will be subject to U.S. tax (U.S. Model Convention, Article 6).

2. A resident of the other treaty country can elect to be taxed on a net-income basis, with the consequences that capital gains would be subject to U.S. tax.

3. The election generally would be irrevocable, except by agreement of officials of the two countries.

4. Capital gains would not be exempt from tax under any other capital gains tax provision (U.S. Model Convention, Article 13).

Furthermore, based on recent public pronouncements of U.S. Treasury officials, negotiators of future treaties will seek to obtain the right for the United States to tax capital gains on the direct or indirect sale of U.S. real estate owned by a U.S. or foreign corporation, if U.S. internal law is amended to include such legislation. It should be noted that U.S. treaty negotiation is a slow process and that no U.S. treaties have been ratified since 1976, although a number have been signed by the President and are waiting ratification in the near future. 16a/

Third-Country Treaties--Netherlands Antilles

A foreign investor residing in a country having a treaty with the United States, which provides the U.S. tax benefits discussed above, can obtain the tax benefits by a direct investment in this nation. If the foreign investor does not reside in such a treaty country, he can nevertheless obtain U.S. tax-treaty benefits by making his investment through a corporation organized in a country other than the one in which he is a resident and has a suitable treaty. Even if his country of residence has a treaty, he can make his investment through a third country which has a more favorable treaty.

Investors in U.S. real estate have used two particularly favorable tax-treaty countries through which to make U.S. real estate (and other) investments. These are the Netherlands Antilles and the British Virgin Islands, which are covered by former U.S. treaties with the Netherlands and the United Kingdom, respectively. Both treaties are old treaties, and the question for investors is whether they will remain in force in their present form.

16a/ On July 9, 1979, the U.S. Senate ratified income tax treaties with Hungary and South Korea. These treaties are not yet in force.

The most common vehicle for foreign ownership of U.S. real property in recent years has been the Netherlands Antilles corporation, taking advantage of the U.S.-Netherlands treaty as extended to the Netherlands Antilles. The general interpretation of the treaty in relation to real estate investment has been approved by the Internal Revenue Service in a published Revenue Ruling. 17/ The procedure for investing through the Netherlands Antilles is as follows:

1. The foreign investor establishes a Netherlands Antilles corporation for each parcel or unit of real property. The lease must be a triple-net lease, to ensure that the corporation is not engaged in a trade or business under internal U.S. tax law.

2. The Antilles corporation elects annually under Article X of the treaty to be taxed on a net-income basis. Article X is as follows:

> A resident or corporation of one of the Contracting States deriving from sources within the other Contracting State royalties in respect of the operation of mines, quarries, or natural resources, or rentals from real property, may elect for any taxable year to be subject to the tax in such other Contracting States on such income on a net income basis.

Thus, an Antilles corporation can elect, on an annual basis, to pay U.S. tax on its net income.

3. In the year of sale, the election is not made and the gain is thus exempt from U.S. tax under U.S. internal tax law.

4. Any dividends and interest distributed by the Antilles corporation are exempt from U.S. withholding tax under Article XII, which states:

> Dividends and interest paid by a Netherlands Antilles corporation shall be exempt from United States tax except where the recipient is a citizen, resident or corporation of the United States.

5. The Netherlands Antilles does not tax income from U.S. real estate by virtue of Article V, which states:

> Income of whatever nature derived from real property and interest from mortgages secured by real property shall be taxable only in the Contracting State in which the real property is situated.

The capital gain on sale of the property can be made tax-free to the seller either by sale of the property or sale of the Antilles corporation's shares.

17/ Rev. Rul. 75-23, 1975-1 C.B.290.

The treaty with the British Virgin Islands also provides broadly similar results and is being used for the same purpose by some foreign investors.

Status of U.S. Tax Treaties

U.S. tax treaties have become a subject of growing interest and concern in Washington in recent years. Formerly, they were fairly simple documents providing principally for reduction in withholding taxes on dividends, interest, royalties, and rentals. Because of the growing complexity of international trade, they have become more complex and specific in overriding internal tax provisions. The U.S. Senate has refused or delayed ratification of treaties in a number of cases when particular Senators, State legislators, or other interested parties have objected to a provision overriding a particular internal U.S. provision.

The use of third-country treaties, known as "treaty-shopping," is an international tax-planning procedure which has gained acceptance by the U.S. Treasury, as evidenced by a published ruling. 18/ Nevertheless, the taxpayer must be able to show that the investing corporation was established for business reasons and not solely for U.S. tax purposes. 19/ From an overall policy standpoint, the use of third-country treaties by foreign investors seems essential if the United States is to obtain foreign investment from those countries with which it has been unable to conclude treaties. It might be noted in this connection that the United States has virtually no treaties with developing countries (including those in Latin America) or Middle East countries. If foreign investors were unable to use third-country holding or investment companies, the U.S. balance of payments, sales of U.S. government securities, and the U.S. stock market could be affected.

In the case of the treaties with countries which are perceived by some as tax havens (which were the subject of hearings by the House Ways and Means Oversight Subcommittee on April 23 and 24, 1979), there is growing criticism that they are used for some tax-evasion purposes. There is thus a question as to whether treaties such as those with the Netherlands Antilles and the British Virgin Islands will remain in effect as presently constituted, or whether they will be modified or even terminated and renegotiated on a completely new basis. As noted by the Treasury's International Tax Counsel, H. David Rosenbloom, at the April 23 and 24 hearings:

> Treaty shopping raises several obvious issues of tax and treaty policy. At the same time, it must be recognized that the practice mitigates the impact of statutory withholding taxes which many persons believe are too high, and constitute an undesirable impediment to investment in the United States by foreigners. Treaty shopping therefore involves some complicated policy choices.

18/ Id.

19/ Perry R. Bass, 50 TC 595 (1968),
Aiken Industries, Inc., 56 TC 925 (1971).

METHODS OF OWNING AND DISPOSING OF REAL ESTATE

Disposition of Real Estate

As regards capital gains taxation, the method of disposing of U.S. real estate significantly affects U.S. taxability of the gain and the party on which that tax falls. Real estate can be disposed of by the owner, e.g., nonresident alien, foreign corporation, U.S. corporation, or other entity such as a U.S. or foreign partnership or trust. In that case, the gain is realized by the selling owner, and the taxability depends on the owner's tax status and the nature of the investment, e.g., passive investor or active enterprise, election under Internal Revenue Code, treaty status, etc., as discussed in the preceding section.

If the real estate is owned by a corporation, there are two basic ways of disposing of the real estate to a third party:

1. By sale of the property itself.

2. By sale of the shares of the property-owning corporation.

As noted earlier, a nonresident alien is not subject to U.S. tax on capital gains from the sale of shares unless he is present in the United States for 183 days or more and the gain has a U.S. source. A foreign corporation is not subject to U.S. tax on capital gains from the sale of shares regardless of source (with very limited exceptions). Thus, one way to sell corporate-owned U.S. real estate is for the shareholder to sell the shares in the corporation owning it. The exemption at the shareholder level also would apply to the sale of shares in a foreign corporation owning the U.S. real estate.

However, when a foreign investor acquires U.S. real estate, the position of the eventual buyer also must be considered. In the case of commercial real estate, a U.S. buyer who is acquiring the real estate for rental purposes or for other business use normally would want to claim depreciation based on the cost of the building. Thus, the buyer usually would prefer to buy the property directly, rather than buying shares of the corporation. If he buys the shares of the property-owning corporation, he would have to liquidate the acquired corporation to obtain a current tax basis for the underlying assets. 20/ Such liquidations result in possible recaptures of excess depreciation deducted by the previous owner.

Another method to achieve the future buyer's objective would be for the corporation owning the property to sell the real property to the buyer and liquidate the corporation under Section 337 of the Tax Code. Under this technique, the buyer acquires the property directly and has a current basis for depreciation. Section 337 exempts the selling corporation from U.S. tax on the capital gain, except for possible recapture of

20/ I.R.C. § 334.

excess depreciation. Generally, the liquidating corporation must not be a subsidiary 80 percent or more of whose shares are owned by a parent company into which it is liquidated. Section 337 applies if the liquidating corporation is owned by individual shareholders, or more than one corporation, so that 80-percent subsidiary status is avoided. Section 337 is inapplicable to a corporation which is considered "collapsible" for U.S. tax purposes.

In all cases where the tax-planning requires a sale of the corporation's shares rather than a simple sale of the property itself, each property must be owned by a separate corporation, so that each property can be disposed of separately. This prevents the owner from consolidating profitable and nonprofitable properties in a single company or in a consolidated group of companies.

These examples are given as an indication of the tax complications to which indirect disposal of U.S. real property can give rise and the sophisticated tax-planning techniques involved. To obtain these U.S. tax advantages, the foreign investor must obtain sophisticated U.S. and international tax advice when planning the acquisition to structure his U.S. investments appropriately.

U.S. Tax Consequences of Methods of Ownership

The previous major section discussed in detail two principal methods of foreign ownership of U.S. real estate. These and a number of other methods are summarized below for comparative purposes:

Direct Ownership by Nonresident Aliens

Direct ownership by a nonresident alien individual has the following U.S. tax consequences:

1. U.S. taxation of rental income, either on a gross (30 percent) basis or net basis.

2. Capital gains taxation or exemption based on nature of investment (active or passive) and elections made.

3. Use of home-country tax-treaty benefits only (if any).

4. Estate or gift taxation on transfers by gift or on death.

5. Limited tax-planning flexibility for investors.

Ownership Through a U.S. Corporation

A common way for an investor to own interests in U.S. real estate is through a U.S. corporation. A number of U.S. States prohibit the ownership of land by foreign corporations, and it is thus not unusual for a foreign investor, corporation or individual, to own the interest in U.S. property through a U.S. corporation.

Such a U.S. corporation would be subject to U.S. tax on income (on a net basis) and capital gains in the same way as a U.S.-owned corporation. However, the income earned from the ownership of the U.S. corporation by the foreign shareholder would be taxed differently from that of a U.S. shareholder. Dividends paid by the U.S. corporation are subject to U.S. withholding tax at 30 percent, unless a lower rate applies under a tax treaty between the United States and the shareholder's country of residence.

The imposition of a dividend withholding tax has a major disadvantage in that it is imposed on all distributions made by the corporation, even if these constitute returns of capital when the earnings and profits eventually are determined. The requirement to withhold income tax on payments that may be capital is contained in the Regulations (but not in the Code itself) and may be subject to some technical question. Nevertheless, the Regulations are clear on this requirement, which could result in a cash-flow detriment to the foreign investor using a U.S. entity to own income-producing real estate.

Capital gains from the sale of the shares normally are not subject to U.S. capital gains tax. The tax consequences of foreign ownership through a U.S. corporation are summarized as follows:

1. Rental income is taxed on a net basis at regular U.S. corporate rates (maximum 46 percent).

2. Dividends paid by a U.S. corporation to its nonresident alien or foreign corporate shareholders out of its earnings and profits are taxed at 30 percent. 21/

3. Earnings and profits of a corporation for purposes of computing dividends are based on depreciation at straight-line rates. 22/

4. Dividends can be taxed at a lower rate if the shareholder is eligible for tax-treaty benefits. The lowest rate available to individual shareholders under most U.S. treaties is 15 percent.

5. The dividend tax is collected by withholding at source. Any distribution, even if the corporation has no earnings and profits and is thus returning capital to its shareholders, is treated as a dividend for withholding-tax purposes and any withholding-tax refund would thus have to await the determination of earnings and profits. 23/

6. The property can be disposed of in a number of ways, including the following:

   a. By sale of the property: U.S. capital gains tax on the corporation.

   b. By sale of the property followed by liquidation of the corporation (Sec. 337): No U.S. capital gains tax on the corporation (but possibly some recapture of depreciation); foreign shareholders normally exempt from capital gains tax.

21/ I.R.C. §§ 871(a)(1)(A) and 881(a)(1).
22/ I.R.C. § 312(k).
23/ Treasury Regulations § 1.1441-3(b).

c. By sale of the corporation's shares: Generally, no U.S. tax on foreign shareholders; buyers can obtain current market-value basis for property by liquidation.

7. Stock of the U.S. corporation is a taxable asset for estate tax purposes if owned by a nonresident individual, but is exempt from gift tax. (See later section on estate and gift taxation.)

8. Reasonable flexibility for tax-planning except for estate tax purposes.

Ownership Through a Foreign Corporation

This type of ownership has the following U.S. tax consequences, which are discussed in detail in the previous section on U.S. taxation of foreign-owned U.S. real estate:

1. U.S. taxation of rental income either on a gross (30 percent) or net basis.

2. Choice of tax-treaty country to make an annual net-basis election in the case of passive investments.

3. Exemption from U.S. tax on dividends paid by the corporation, generally available under the appropriate tax treaty.

4. Exemption from U.S. tax on interest paid to foreign lenders under the appropriate tax treaty.

5. The property can be disposed of in a number of ways, including sale of the property, sale of the shares, or liquidation of the corporation.

6. The shares of a foreign corporation are not subject to either estate or gift taxes in the case of a nonresident alien shareholder. (See following major section.)

7. This structure provides the maximum flexibility for tax-planning and also greater complexity.

Other Vehicles

Other possible vehicles of ownership of U.S. real estate include U.S. and foreign trusts, partnerships (possibly comprising corporate as well as individual partners), and real estate investment trusts or other types of mutual funds investing in U.S. real estate. Joint ventures between foreign and domestic investors can offer an advantage because they can be arranged to give the domestic investor a share of the losses and the foreign investor a share of the capital gain. One method of doing this could be to have the foreign investor own the land and the domestic investor own the depreciable commercial property on the land. Further discussion of the U.S. consequences of these various permutations is beyond the scope of this study.

Other U.S. Tax Provisions

A number of U.S. penalty tax provisions apply to shareholders of corporations owning U.S. real estate, including personal holding company provisions, accumulated earnings tax, and collapsible corporation rules. These provisions are considered to be beyond the scope of this study.

ESTATE AND GIFT TAXATION OF REAL ESTATE TRANSFERS

The preceding sections discussed the U.S. tax consequences of disposing of U.S. real estate by sale and the complexities involved in minimizing the capital gains tax. In this section, the U.S. taxation of gratuitous transfers is discussed. The United States imposes three kinds of taxes on transfers of property by gift or on death:

1. The estate tax, which applies to transfers at death.

2. The gift tax, which applies to life-time transfers.

3. The tax on generation-skipping trusts.

Transfers by U.S. Citizens and Resident Aliens

The Tax Reform Act of 1976 unified the estate and gift tax rates, which now are imposed at graduated rates ranging from 18 to 70 percent on taxable estates and on transfers of property by gift over a person's life. The U.S. tax reaches the rate of 70 percent on taxable gifts and estates in excess of $5 million.

Transfers by a U.S. citizen or resident alien are subject to these taxes with respect to worldwide assets, and credits are allowed against the U.S. estate tax for foreign death taxes. 24/

Taxable estates include transfers of real estate, generally at current market value at the time of the transfer. As noted previously, prior to the Tax Reform Act of 1976, assets transferred by a decedent received a new current market value basis in the hands of the heir for future capital gains tax purposes. The Tax Reform Act of 1976 introduced a new "carry-over-basis" rule, which has been the subject of considerable controversy and the application of which has been delayed until 1980.

The tax on generation-skipping trusts is a separate tax to ensure taxation of trust benefits which otherwise escape gift and estate taxes.

Transfers by Nonresident Aliens

Transfers made by nonresident aliens of property having a U.S. situs also are subject to U.S. estate and gift taxes, but on a much more limited basis.

24/ I.R.C. § 2014.

Estate Tax

As in the case of capital gains taxation, the United States follows general principles of international tax law and practice, which recognize that the country of a decedent's domicile has the right to tax worldwide assets passing in an estate. Nevertheless, the country in which an asset is located or has its "situs" is considered to have the first right to tax on transfers, and this has, in particular, been the practice internationally as regards real property. On the other hand, shares in corporations generally are considered to have their situs in the country where the corporation in incorporated and not in the country where the corporate shares are located. Thus, for U.S. estate tax purposes, shares of a foreign corporation are property situated outside the U.S. 25/ U.S. real property owned directly by a nonresident alien decedent has its situs in the United States. 26/

A nonresident alien decedent is subject to U.S. estate tax with respect to U.S. situs property only. The U.S. estate of a nonresident alien would include real property owned directly or through a U.S. corporation. However, it would not include U.S. real property owned through a foreign corporation. Thus, for wealthy foreign investors, there are important U.S. estate tax advantages in using a foreign corporation to hold U.S. real estate, which may be a more important overall tax consideration than the possible exemption from capital gains tax on sales. The foreign investor may be subject to estate taxes in his country of domicile.

A further difference in the taxation of nonresident aliens is that U.S. taxable estates of nonresident aliens are subject to much lower tax rates than those of U.S. citizens--from 6 percent to 30 percent, which is reached on estates of over $2 million.

Gift Tax

A nonresident alien is subject to U.S. gift tax in very limited circumstances only, namely on gifts of tangible U.S. property. Shares of corporations are intangible property for gift-tax purposes. Thus, a nonresident alien is taxed on lifetime gifts only with respect to property which is both tangible and situated in the United States. 27/ A gift of U.S. real estate owned directly by a nonresident alien is subject to U.S. gift tax, but a gift of U.S. real estate owned either by a U.S. or foreign corporation is exempt from U.S. gift tax.

There is no special rate table for lifetime gifts of nonresident aliens and, consequently, the higher U.S. estate- and gift-tax table applies--a curious anomaly resulting in higher gift-tax rates than estate-tax rates for nonresident aliens.

25/ I.R.C. § 2104(a).
26/ Treasury Regulations § 20.2104-1(a)(1).
27/ I.R.C. § 2501(a)(2).

Estate- and Gift-Tax Treaties

The United States has a small number of estate-tax and gift-tax treaties in force. 28/ The provisions of these treaties override the provisions of U.S. internal tax law. These treaties generally allocate taxing rights in the case of decedents domiciled in one country with assets in another country. In the case of the present U.S. treaties, they do not alter the U.S. estate- and gift-tax exemptions for nonresident aliens owning U.S. real estate through a foreign corporation.

In view of the estate tax exemption for shares of a foreign corporation owned by a nonresident alien, it is evident that for all but minor holdings in U.S. real estate, the foreign investor normally would be well advised to own his property through a foreign corporation--with a view to avoiding the tax and legal costs and complications of having such property subject to U.S. estate taxes.

TAXATION OF REAL ESTATE IN THE INTERNATIONAL CONTEXT

To place U.S. taxation of foreign-owned U.S. real estate into an international context, we reviewed the relevant foreign tax provisions with our foreign offices.

First, we sought to determine whether investors from seven major countries are subject to tax in their home countries (countries of residence, since most countries do not tax on the basis of citizenship), on U.S. real estate income and capital gains, and whether U.S. property is subject to estate tax. To the extent that such income is taxed in the foreign country, the exemption from U.S. tax is of relatively lesser importance in making the investment decision..

We also asked whether the home country would tax such investments if the real estate were owned through a local (resident) corporation or a foreign corporation. In addition, we asked whether such taxes could be reduced or avoided by use of tax treaties.

Second, we sought to determine how other countries tax foreigners, e.g., U.S. investors who own property in their countries. The question was divided into direct ownership, ownership through a foreign corporation resident in the country where the real estate is located, and ownership through a nonresident corporation. Estate taxes were covered, as was the question of whether the taxes could be reduced or eliminated by use of tax treaties.

28/ The United States has gift-tax treaties currently in effect with Australia and Japan and has estate-tax treaties in force with the following countries: Australia, Canada, Finland, France, Greece, Ireland, Italy, Japan, Netherlands, Norway, Switzerland, South Africa, and United Kingdom.

The results of our survey are tabulated on the following pages. It should be noted that the responses were required in "yes/no" form. Consequently, details, provisos, and exceptions are not noted. The answers are intended to give a broad picture on which general conclusions can be based.

Based on this survey (questions A, B, and C), it appears that foreign investors who own U.S. real estate directly would be subject to tax in their countries of residence on rent received and on capital gains. It should be noted, however, that many major European countries do not generally tax capital gains at all, including, in our survey, Germany and the Netherlands. Italy taxes gains of individuals only if the investment is entered into with speculative intent. Directly owned real estate also would be included in the estate or inheritance tax base in those countries which have such taxes.

However, in all countries surveyed, it was possible for the foreign investor to pay no tax in his home country on rents or capital gains earned by ownership of U.S. real estate through a foreign corporation. This general rule might be modified in countries which impose current tax on undistributed income, similar to the Subpart F and foreign personal holding-company provisions of the U.S. Tax Code. The tables do not deal with these situations.

As regards the foreign taxation of U.S. investors in foreign real estate (questions D, E, and F), our survey shows that the foreign country would subject rents received by a foreign (e.g., U.S.) investor in real estate to their taxes. These taxes are either imposed by withholding at source or on a net-income basis and may be affected by tax-treaty elections, as in the case of U.S. rentals.

Capital gains on sales of the property by foreign (U.S.) investors would be taxable only in some of the countries. Some do not tax capital gains, as noted above. Others do not tax foreign owners of local assets, in accordance with international tax concepts of allocating taxing rights to the jurisdiction of the country of the investor's residence.

Directly owned real estate generally is included in the foreign country's estate or inheritance tax base.

If the foreign (U.S.) investor owns the foreign real estate through a foreign corporation, rents received by the foreign corporation would be taxed locally and capital gains generally would also. However, the foreign tax can be avoided if the foreign (U.S.) investor sells the shares of the foreign corporation instead of selling the property. The sale of shares can also avoid the foreign tax in several countries even if the real estate is owned by a resident corporation. Thus, there appears to be little fundamental difference in the way the United States and many foreign countries tax foreign-owned real estate.

SURVEY RESULTS

Foreign-Country Taxation of U.S. Real Estate Investments

A. This part asks the question: How does the country tax individual residents on their investments in U.S. real estate? Can the tax be reduced or eliminated under the country's tax treaty with the U.S.?

Questions

A.1. Does the country tax rent received on directly owned U.S. real estate:

A.1.T. Does the income tax treaty reduce or eliminate the tax?

A.2. Does the country tax capital gains on sale of directly owned U.S. real estate?

A.2.T. Does the treaty reduce or eliminate the tax?

A.3. Is U.S. real estate included in the country's estate or inheritance tax base?

A.3.T. Does the estate tax treaty reduce or eliminate the tax?

Answers

	A.1(2)	A.1.T.	A.2.(8)	A.2.T.	A.3.	A.3.T.
Canada	Yes	No	Yes	No	No(7)	N/A
France	Yes	Exempt(1)	Yes	Exempt(1)	Yes	No
Italy	Yes	Exempt	Yes(4)	No	Yes	No
Netherlands	Yes	Exempt	No(5)	N/A	Yes	No
Spain	Yes	N/A(3)	Yes	N/A(3)	Yes	N/A(3)
United Kingdom	Yes	No	Yes	No	Yes	No
West Germany	Yes	Exempt(1)	No(5)	N/A(6)	Yes	N/A(3)

(1) Income is taken into account in determining the tax rate applicable to other income ("Exemption with progression").

(2) Credit is allowed for foreign taxes in a number of countries. These have not been noted in this table.

(3) No treaty with U.S.

(4) Unless the property is not held with speculative intent.

(5) Property assumed not to constitute a trade or business.

(6) Treaty exemption also available.

(7) Canada has no estate tax, except in Quebec province. However, capital assets are deemed disposed of generally at fair market value on death and subject to capital gains tax.

(8) Some countries impose substantial transfer taxes on transfers of real property or business property. These are not covered in this table.

(9) It is assumed that the investor does not hold a substantial interest in the corporation.

(10) The amount of gain taxable is reduced or eliminated proportionately for the number of years the property is held.

(11) Interest is not taxable.

(12) If the value of the real estate is more than 50 percent of the total assets of the corporation, the sale of the shares is considered as the direct sale of real estate and the capital gains are taxable.

B. This part asks the question: How does the country tax the income if the individual owns the U.S. real estate through a locally organized or resident company?

Questions

B.1. Does the country tax rent received by the local corporation?

B.1.T. Does the income tax treaty reduce or eliminate the tax?

B.2. Does the country tax capital gains from sale of U.S. real estate?

B.2.T. Does the treaty reduce or eliminate the tax?

B.3. Does the country tax dividends and interest received by the domestic shareholder from the resident corporation?

B.4. Does the country tax capital gains from the sale of the corporation's stock?

B.5. Is the resident corporation's stock included in the country's estate or inheritance tax base?

Answers

	B.1.	B.1.T.	B.2.	B.2.T.	B.3.	B.4.	B.5.
Canada	Yes	No	Yes	No	Yes	Yes	No (7) */
France	No	N/A	No	N/A	Yes	Yes	Yes
Italy	Yes	No	Yes	No	Yes	No	Yes
Netherlands	Yes	Exempt	Yes	No	Yes	No (9)	Yes
Spain	Yes	N/A (3)	Yes	N/A (3)	Yes	Yes	Yes
United Kingdom	Yes	No	Yes	No	Yes	Yes	Yes
West Germany	Yes	Exempt (1)	Yes	Exempt (1)	Yes	No (9)	Yes

*/See notes in A.

C. This part asks the question: How does the country tax the income if the individual owns the U.S. real estate through a foreign corporation?

Questions

C.1. Does the country tax rent received or capital gains realized by the foreign corporation?

C.2. Does the country tax dividends and interest received from the foreign corporation?

C.3. Does the country tax capital gain from the sale of the corporation's stock?

C.4. Is the foreign corporation's stock included in the country's estate or inheritance tax base?

Answers

	C.1.	C.2.	C.3.	C.4.
Canada	No	Yes	Yes	No (7) */
France	No	Yes	Yes (10)	Yes
Italy	No	Yes	No	Yes
Netherlands	No	Yes	No (9)	Yes
Spain	No	Yes	Yes	Yes
United Kingdom	No	Yes	Yes	Yes
West Germany	No	Yes	No (9)	Yes

*/See notes in A.

D. This part asks the question: How does the country tax foreign or non-resident owners of real estate in the country?

Questions

D.1. Does the country tax rent received on directly owned foreign real estate?

D.2. Does the country tax capital gains on the sale of foreign owned real estate in the country?

D.3. Does the country include foreign owned real estate in its local estate or inheritance tax base?

Answers

	D.1.	D.2.	D.3.
Canada	Yes	Yes	No(7) */
France	Yes	Yes(10)	Yes
Italy	Yes	Yes(4)	Yes
Netherlands	Yes	No(5)	Yes
Spain	Yes	Yes	Yes
United Kingdom	Yes	No(5)	Yes
West Germany	Yes	No(5)	Yes

*/See notes in A.

E. This part asks the question: <u>How does the country tax foreign-owned real estate owned through a resident corporation?</u>

Questions

E.1. Does the country tax rent received and capital gains on the sale of real estate owned through a resident corporation?

E.2. Does the country tax dividends and interest paid by the resident corporation to the foreign shareholder?

E.3. Does the country tax capital gains from the sale of stock of the resident corporation?

E.4. Does the country include the stock of the resident corporation in its estate or inheritance tax base?

Answers

	E.1.	E.2.	E.3.	E.4.
Canada	Yes	Yes	Yes(*)	No(7) **/
France	Yes	Yes	No(12)	Yes
Italy	Yes	Yes	Yes(4)	Yes
Netherlands	Yes	Yes(11)	No(*)	No
Spain	Yes	Yes	Yes	Yes
United Kingdom	Yes	Yes	No	Yes
West Germany	Yes	Yes	No(*)	Yes

(*)Exempt under U.S.-Canada treaty.

**/See notes in A.

F. This part asks the question: How does the country tax foreign-owned real estate owned through a foreign (nonresident) corporation?

Questions

F.1. Does the country tax rent paid to a foreign corporation?

F.2. Does the country tax capital gains on sale of property by the foreign corporation?

F.3. Does the country tax capital gains from the sale of stock of the foreign corporation?

F.4. Is the stock of the foreign corporation included in the country's estate or inheritance tax base?

Answers

	F.1.	F.2.	F.3.	F.4.
Canada	Yes	Yes	No	No (7) */
France	Yes	Yes	No	No
Italy	Yes	Yes	No	No
Netherlands	Yes	Yes	No	No
Spain	Yes	Yes	No	No
United Kingdom	Yes	No (5)	No	No
West Germany	Yes	No	No	No

*/See notes in A.

TABLE OF U.S. TAX TREATIES AND PROVISIONS AFFECTING FOREIGN OWNERSHIP OF U.S. REAL ESTATE. SOURCE: DEPARTMENT OF THE TREASURY, MAY 1979

TABLE 4-1

Selected Provisions of U.S. Income Tax Treaties Affecting Foreign Ownership of U.S. Real Property

Country	Date of signature of of treaty or most recent protocol (P)	Annual net basis election	Waiver of U.S. second dividend tax	Waiver of U.S. second interest tax	Treatment of capital gains in U.S.: General source exemption	Exceptions to source country exemption: real property	P.E. or fixed base property	183 day presence in source state	other
Antigua 1/	1958	x	x	x					
Australia	1953	x	x 2/						
Austria	1956	x	x	x					
Barbados 1/	1958	x	x	x					
Belgium	1970		x	x 10/	x	x	x	x	
Belize 1/	1958	x	x	x					
British Virgin Islands 1/	1958	x	x	x					
Burundi 3/	1959	x							
Canada	1966 (P)	x	x	x	x		x		
Denmark	1948	x							
Dominica 1/	1958	x	x	x					
Egypt 4/	1975			x 10/	x	x	x	x	
Falkland Islands 1/	1958	x	x	x					
Finland	1970				x	x	x	x	
France 5/	1978 (P)	x		x 10/	x	x	x	x	x 5/
Gambia 1/	1958	x	x	x					
Germany	1965 (P)	x	x	x	x	x	x	x	
Greece	1950	x	x	x					
Grenada 1/	1958	x	x	x					
Hungary 4/	1979			x	x	x	x		
Iceland	1975		x	x 10/	x	x	x	x	
Ireland	1949	x	x	x					
Israel 4/	1975		x	x 10/	x	x	x	x	x 7/
Italy	1955	x	x	x					
Jamaica 1/	1958	x	x	x					
Japan	1971		x	x 10/	x	x	x	x	
Korea 4/	1975		x	x 10/	x	x	x	x	
Luxembourg	1964	x	x	x					

cont.

TABLE 4-1

(Continued)

Selected Provisions of U.S. Income Tax Treaties
Affecting Foreign Ownership of U.S. Real Property

Country	Date of signature of of treaty or most recent protocol (P)	Annual net basis election	Waiver of U.S. second dividend tax	Waiver of U.S. second interest tax	Treatment of capital gains in U.S.				
					General source exemption	Exceptions to source country exemption: real property	P.E. or fixed base property	183 day presence in source state	other
Malawi 1/	1958	x	x	x					
Montserrat 1/	1958	x	x	x					
Morocco 4/	1977		x	x 10/	x	x	x	x	x 6/
Netherlands	1965(P)	x	x	x	x	x	x	x 8/	
Netherlands Antilles 9/	1963(P)	x	x	x					
New Zealand	1948	x	x						
Norway	1971		x	x 10/	x	x	x	x	
Pakistan	1957		x						
Philippines 4/	1976			x 10/	x	x	x		
Poland	1974			x 10/	x	x	x	x	
Romania	1973			x 10/	x	x	x	x	
Rwanda 3/	1959	x							
St. Christopher, Nevis & Anguilla 1/	1958	x	x	x					
St. Lucia 1/	1958	x	x	x					
St. Vincent 1/	1958	x	x	x					
Seychelles 1/	1958	x	x	x					
Sierra Leone 1/	1958	x	x	x					
Sweden	1963(P)				x	x	x		
Switzerland	1951	x	x 2/	x 2/					
Trinidad & Tobago	1970	x		x 10/					
Union of South Africa	1950(P)	x							
U.S.S.R.	1973								
U.K. - present treaty	1966(P)	x	x	x	x		x	x	
U.K. - proposed treaty 4/	1979(P)		x	x 10/					
Zaire 3/	1959	x							
Zambia 1/	1958	x	x	x					

Office of the Secretary of the Treasury
Office of Tax Analysis

1/ 1978 extension of U.K. treaty as in effect at that time.
2/ Payments are exempt from U.S. tax only if paid to residents of the other country.
3/ 1959 extension of Belgian treaty as in effect at that time.
4/ Signed but not yet in force.
5/ The 1978 protocol is signed but not yet in force.
6/ Country of situs of real property may tax gain on sale of shares or similar interests in real property cooperative or corporation whose assets consist principally of that property.
7/ A U.S. resident is taxable by Israel on gain from the alienation of shares in a real estate holding company. A protocol which is not yet signed will make this provision reciprocal.
8/ Source right to tax applies only if asset is held less than 6 months.
9/ 1955 extension of Netherlands treaty as then in effect, as amended by a 1965 protocol.
10/ Though the United States does not preserve the precise form and scope of the second-interest tax, it does retain the right to tax interest paid by a resident of the other state, if the payor has a P.E. in the United States in connection with which the indebtedness was incurred, and which bears the interest.

Source: Taxation of Foreign Investment in U.S. Real Estate, supra. note 2, at 39.

APPENDIX II: USE OF TAX RETURNS AS A FOREIGN INVESTOR DATA SOURCE */

Extent of Availability Under Current IRS Procedures

Prior to the Tax Reform Act of 1976, there were a number of situations in which individual income tax returns could be disclosed by the Internal Revenue Service (IRS) to other Federal agencies requesting to inspect the returns. Every Federal agency had access to tax returns upon the written request of the head of the agency and the approval of the Secretary of the Treasury or the IRS Commissioner. IRS regulations also permitted a few specific agencies to have general access to returns, usually for statistical purposes but also for other purposes, such as to improve the administration of Government programs (e.g., the Federal Trade Commission).

The Tax Reform Act of 1976 severely limited the amount of individual tax-return information which can be shared legally with other Federal agencies or disclosed to the public. Research or statistical projects conducted by certain specified agencies may use tax-return information, but these agencies may not release any information which could be directly or indirectly associated with a particular taxpayer. Case-by-case disclosure of individual returns to other agencies has been considerably reduced, as in the case of providing information to White House officials. In this case, written request and justification, personally signed by the President, is now required before tax-return information can be disclosed to the White House.

The IRS currently prepares and publishes a number of summaries of tax-return information. Foremost among these are the Statistics of Income-Corporation Income Tax Returns and the Statistics of Income--Individual Income Tax Returns. These volumes contain various types of aggregate data, such as balance-sheet information, by type of business and type of form submitted.

A complete discussion of the real estate data which are reported and disclosed in aggregate form is contained in the section of this report discussing the study of the feasibility of Federal systems to monitor foreign investment in U.S. real estate (Scenarios I and II). That section provides an analysis of the real estate information reported and disclosed in each of the following tax returns:

1. U.S. Corporation Income Tax Return (Form 1120).
2. U.S. Income Tax Return of a Foreign Corporation (Form 1120F).
3. U.S. Nonresident Alien Income Tax Return (Form 1040NR).
4. United States Estate Tax Return--Estate of Nonresident Not a Citizen of the U.S. (Form 706NA).

Conflicts Between Tax Collection and Information Source Uses

Under the present tight restrictions against disclosure of individual taxpayer information, there should be less reluctance on the part of taxpayers to supply the IRS with information. Such reluctance could increase if the

*/ Source: General Explanation of the Tax Reform Act of 1976, prepared by the Joint Committee on Taxation, December 29, 1976.

laws limiting tax-return information disclosure were amended to permit disclosure of information on nonresident alien individuals and entities. While it is outside the scope of this portion of the project to comment on the political feasibility of such legislative proposals, we can note that the Congress has enacted several laws within the last 5 years which provide for much less Federally collected data being disclosed. Examples of this include the disclosure restrictions in the Tax Reform Act of 1976 mentioned above and the Privacy Act of 1974. It also should be mentioned that, due to the numerous cases in which a foreign investor has only a partial interest in a given company or partnership, the disclosure of individual income tax data on that entity would result in information being released which affects U.S. citizens as well. This fact may have its own legal implications, which would further lessen the feasibility of disclosing individual foreign investor tax-return data.

If such legislative changes were made, they could result in investors being reluctant to comply with certain reporting requirements on Form 1120--U.S. Corporation Income Tax Return, and with other tax returns for individuals. The Form 1120 calls for identification of foreign entities which have a 50-percent or more ownership in the corporation reporting. Certain other information, such as that required on Schedule D (Capital Gains and Losses), might contain information of a sensitive nature if disclosed. Further discussion of the type of beneficial owner and real estate information in tax returns is presented in the above-mentioned report on Federal systems to monitor foreign investment in U.S. real estate.

Chapter 18

INTERGOVERNMENTAL EXCHANGE OF FOREIGN INVESTMENT INFORMATION

Bruce Zagaris*/

INTRODUCTION

This chapter discusses the possibilities of the United States exchanging information with foreign countries as a means of monitoring foreign direct investment in the United States, especially real estate.

After discussing the issues of what information, what accessibility, and for what purposes, this chapter describes mechanisms used by the United States and other countries to exchange information of the same or similar types. The laws and practices surrounding the use of these mechanisms are discussed. The chapter also discusses conventions of mutual assistance in criminal matters and multilateral European agreements concerning exchanges of information. Finally, the use of exchange of information to solve the layering problems resulting from multitiered structures in tax havens for foreign investments in U.S. real estate are considered.

A pivotal issue which must be addressed before ascertaining which mechanisms are available to the United States to arrange for the exchange of information is what types of information will be exchanged, to whom it will be available, and for what purposes it will be used.

The United States can exchange information useful primarily or only for statistical purposes. Such information would consist of: the nationality of the investor; the type of investment (e.g., sectoral classification employed by the U.S. Department of Commerce); the value of the initial investment if a new investment; financial and operating data of the investment vehicle; composition of internal and external financing; number and types of employees and compensation paid; and whether the foreign investor has U.S. and/or foreign affiliates (and the nationality of the latter where applicable). This information is available to the U.S. Government through BE-15 reports which certain persons, unless

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otherwise exempted, are required to file with the Department of Commerce pursuant to the International Investment Survey Act of 1976. However, the law currently provides that the information contained in these reports is available only to officials and employees of agencies designated by the President to perform functions under the Act. It appears that an amendment will be required to authorize exchanging the information with foreign governments.

In addition to the aforementioned information, the U.S. Government can exchange more specific information, including the name of the investor, his or her address, directors and officers of a corporation where applicable, taxes paid, and so forth. This information often is referred to as of an "intelligence" nature.

The persons to whom the information is available would most likely be limited to government officials having responsibility for collecting and analyzing statistics and forming policy on international investments to and from the United States. If intelligence information is exchanged, a broader spectrum of government persons would be included, such as those persons having responsibility for enforcement of tax, criminal, and reporting laws (e.g., the Treasury Department for foreign bank account reporting forms[1/] and the Securities and Exchange Commission for enforcement of Section 103 of the Foreign Corrupt Practices Act.[2/]) The public should not be given access to this information, since the United States has taken the position that public disclosure of these reports can result in discrimination against foreign investors and thus the reports become a regulatory screening mechanism. A shift by the United States from a reporting system to a screening mechanism would be unnecessary and not in our national interest. In addition, making such

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1/ Hearings on Offshore Tax Havens before the Subcomm. on Oversight, House Comm. on Ways and Means, 96th Cong., 1st Sess. (hereinafter referred to as Hearings on Offshore Tax Havens), April 25, 1979, remarks of Richard L. Fogel, Associate Director of the General Government Division, General Accounting Office, stating that the establishment of the Department of Treasury Enforcement Communications System will provide central national processing of the data, instead of processing and dissemination by I.R.S. service centers only, and that transferring jurisdictions responsibility from the I.R.S. to the Dept. of Treasury removes confidentiality requirements and facilitates use by other government agencies such as the Drug Enforcement Administration and the Customs Service.

2/ The Foreign Corrupt Practices Act of 1977. Pub.L.No. 95-213, tit. I, 91 Stat. 1494, amending 15 U.S.C. secs. 78q(b), 78dd, 78ff(a) (1976). A person intentionally failing to file reports required by Federal (e.g., B.E.A. and AFIDA reports) or State law may also constitute a failure to maintain accurate accounting records under Section 103, and thereby subject certain foreign persons, such as issuers, to criminal liabilities under this Act in addition to penalties applicable under other laws.

reports public discourages foreign investors from reporting and actually results in less information.[3]

The uses of the information exchanged would be to analyze the impact of direct foreign investments into and out of the United States, including the impact on: the U.S., foreign, and international economy; employment; efficient use of scarce resources; and consistency with U.S. defense and legal as well as sociopolitical objectives. The uses of Agricultural Foreign Investment Disclosure Act (AFIDA) and Bureau of Economic Analysis (BEA) reports presumably would be embraced by the broader uses mentioned above. If intelligence information is exchanged, its uses should be limited to prosecute designated crimes. Without careful limitation of the information exchanged, the rights of U.S. and foreign persons may be violated, and foreign countries will not want to make exchange of information agreements.[4]

ADVANTAGES AND DISADVANTAGES OF INTERGOVERNMENTAL EXCHANGE OF INFORMATION

Advantages

The advantages of exchanging information vary according to whether the information exchanged is of a statistical or intelligence nature.

The exchange of statistical information would enable the U.S. Government to verify some of its statistics and to identify gaps in information and the reasons for such gaps. The utility of such information exchange to the United States would depend on the extent to which a foreign country collects or agrees to collect such information and whether uniform categories for collecting such information can be made. Many countries which are the sources of foreign direct investment into the United States require that, prior to taking out of the country a specified sum of money, a person must apply for authorization. The application usually requires the applicant to set forth the place and types of the proposed investment and other information concerning the proposed investment.[5] Such information could be utilized by the United States to verify its information. Similarly, information maintained by the

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3/ International Investment Survey Act: Hearings on Increasing the Authorization of Appropriations before the Subcomm. on International Economic Policy and Trade, House Comm. on Foreign Affairs, 96th Cong., 1st Sess., April 26, 1979 (statements of D. Meissner, Deputy Asst. Sec. for International Finance and Development, Bur. of Econ. and Bus. Aff., Dept. of State, and M. Berger, Office of Foreign Investment in the United States, Dept. of Commerce).

4/ See Hearings on Offshore Tax Havens, supra note 2 (remarks by Harvey Dale, Joe Guttentag, & Marshall Langer).

5/ Countries requiring reporting or approval for use of domestic currency include Austria, France, Japan, Sweden, Italy, Belgium, Luxembourg, and the United Kingdom. See 7 Martindale-Hubbell Law Directory (1979).

host countries on foreign direct investment pertaining to investments by U.S. persons can be utilized by the U.S. Government to verify statistics on outbound direct investments of U.S. persons.

Both the U.S. and foreign governments can use statistical information to analyze the balance of payments, types of international investments, trends in international investments, geographical concentration of investments, sectoral allocation of investments, impacts on employment, and needs to make macroeconomic and international economic adjustments.

Additional advantages would accrue to the United States and foreign countries exchanging intelligence information. In the first example, a foreign direct investment in the United States is used. In all examples, the reverse, a U.S. direct investment may be involved and the interests of the United States and the foreign country are reversed. The U.S. Government would be able to more effectively detect evasion of tax on the income of a nonresident alien from interest, dividends, etc. in the United States. Currently, the United States has an address type of withholding under which a nonresident alien wanting to invoke a reduced withholding rate of taxation on U.S. income merely gives an address on the withholding form in the treaty country selected. Little or no attempt is now being made to verify the accuracy of the address given. Exchanging information also can reveal the misuse of a tax treaty by a nonresident alien, the use of bearer securities, and the wrong categorization on a U.S. or other tax return to minimize withholding taxes.

Exchanging information may assist countries in determining undeclared interest, dividends, and rental income from foreign sources accruing to residents of its country.

The nondeclaration or underdeclaration by a resident of one country of his business profits from foreign sources may be uncovered by exchanging information on the acquisition of property or another major investment.

Overstatements by nonresident taxpayers doing business within a foreign country or by taxpaying enterprises controlled by nonresidents doing business within the country or by domestic enterprises abroad--of expenses for services rendered within the country to such taxpayers by nonresident technicians and experts not affiliated with such taxpayers--may be used to impermissibly reduce income.

Transactions of purchase and sale, interest payments, management fees, etc., between affiliated taxpayers at unrealistically inflated prices also can be detected by exchanging information.

Use of "holding companies" or other agents located in foreign countries to receive income directly or indirectly accruing to a resident of a country from sources in foreign countries can be found by information exchange.

Use of bearer shares issued by enterprises situated in a country by nonresidents of that country so that the nonresidents can evade taxes may be detected by exchange of information.

Bearer shares issued abroad may be used by residents of a country to evade taxes of his country on his income from foreign sources. Hence, a Belgian resident may use bearer shares to hold stock in a Swiss company investing in the United States. Perhaps, by looking at the information exchanged, Belgian authorities may become suspicious that the Belgian resident, who unknown to them owns the bearer shares, is an officer or director in several German companies owning U.S. real estate. Their suspicions may lead to an investigation or to a request for additional information from Germany under either the Belgian-German tax treaty or the European Economic Community (EEC) directive on exchange of information under tax treaties (discussed below).

The information exchanged can be used to detect and prosecute diverse types of criminals, such as those involved in organized crime, narcotics trafficking, customs violations, etc.[6]

Disadvantages

The principal disadvantage of the exchange of information is that the commitments by the United States and other countries to national treatment of foreign enterprises and an open-door policy may be eroded substantially by entering into agreements to exchange information. Some foreign investors will inevitably interpret these agreements as intended to discriminate against them or will switch their investments to countries in which they can be more certain that their investments will be kept private and anonymous. In many cases, the perceptions of the investors are more important than the actual policies of the contracting parties.

Another important disadvantage, also mentioned above, is that some foreign investors who would report if they believe the information will be kept confidential will fail to report if they know that the information will be exchanged abroad. For instance, an investor, acquainted with U.S. laws such as the Freedom of Information Act and the Right to Privacy Act and publicized instances in which confidential government information has been revealed, may believe that his goal of having his or her investment be anonymous is jeopardized.

INFORMATION EXCHANGED PURSUANT TO U.S. BILATERAL TAX TREATIES

The United States has bilateral conventions for the avoidance of double taxation and the prevention of fiscal evasion with respect to income taxes with 38 countries, as well as with 7 territories of the United Kingdom and 1 territory of the Netherlands. In addition, the United States has in force 13 conventions for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes and estates.

6/ Tax Treaties Between Developed and Developing Countries at Section V (5th Report, U.N. Publication 1975).

Applicable U.S. Statutory Law

Two important provisions of the Internal Revenue Code, Sections 6103(k)(4) and 7213, must be considered in analyzing the operation of information exchange under tax treaties.

Section 6103(k)(4) provides that "a return or return information may be disclosed to a competent authority of a foreign government which has an income tax convention with the United States but only to the extent provided in, and subject to their terms and conditions of, such convention."

The Tax Reform Act of 1976 altered and codified prior rules concerning income tax disclosure. The new rules forbid disclosure except as specifically provided in Section 6103. The Act amended Section 7213 to provide that disclosure of "any return or return information" by a Federal official except as authorized in this title (of the Code) is punishable by imprisonment for 5 years or a fine of $5,000 or both. These increased penalties are designed to make Internal Revenue Service officials more cautious about supplying return information under tax treaties.[7/]

Purposes

The different bilateral tax treaties of the United States have substantially the same terms and provide that the authorities shall exchange information which they have or which is available under their respective tax laws to carry out the provisions of the treaty, for the prevention of fraud, or for the administration of statutory provisions against avoidance of tax. In some of the treaties, the distinction is made between the information exchanged as a matter of routine and that requested by one of the states. Other treaties are more general as to the purposes and methods of exchange. All the treaties contain limitations which enable the contracting parties to refuse to exchange information protected by the limitations.[8/]

Types of Information Exchanged

Three types of information are provided for in the exchange of information provisions of bilateral tax treaties. The first is information which is routinely exchanged. The second is information which is specifically requested by a treaty partner. The third is that the competent authorities of the treaty partners must notify each other concerning changes in the respective tax laws, or, according to the U.S. model income tax treaty, concerning official published material on the

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7/ Guttentag, Exchange of Information under U.S. Tax Treaties, in Foreign Tax Planning 1977 565 (Practicing Law Institute 1977).
8/ Shockey, Exchange of Information Provisions in the United States Tax Treaties, 1978 Tax Mgmt. Int'l J. 8.

application of the treaty, including explanations, regulations, rulings, or judicial decisions.9/

Some treaties set forth in detail the first two kinds of information which are to be exchanged. The U.S.-Canada treaty has a general provision for the exchange of information between the contracting states, which the competent authorities have at their disposal or are in a position to obtain in the ordinary course or upon request, for the purpose of preventing fiscal evasion.10/ The next article of the U.S.-Canada treaty provides for mandatory exchange of the names and addresses of persons having addresses in one of the countries and a source of income in the other and deriving dividends, interest, rents, royalties, salaries, wages, pensions, annuities, or other fixed or determinable annual or periodical profits and income.11/ The U.S.-Swedish bilateral tax treaty has an even more detailed list of the items to be mandatorily exchanged.12/

Most of the treaties contain only short and simple exchange of information provisions and provide more detail in the regulations or other administrative provisions rather than in the articles of the treaties.

Some treaties, such as the one with the Netherlands, provide only for the exchange of information in certain defined categories, such as information "necessary for carrying out the provisions of the present Convention," and information "necessary for the prevention of fraud or the administration of statutory provisions against legal avoidance in relation to the taxes which are the subject of the present Convention."13/

The current U.S. model income tax and estate and gift tax treaties, which serve as the starting position for the United States in negotiations, contain very broad information exchange provisions. They cover any information "necessary for carrying out the provisions of the convention or the domestic laws of the Contracting States concerning taxes covered by the convention insofar as taxation thereunder is not contrary to the convention." The model conventions also provide that,

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9/ Id. See U.S. Dept. of Treasury, Model Income Tax Treaty, Art. 2(3) (May 18, 1976), reprinted in Foreign Tax Planning 505-6 (Practicing Law Institute 1977). Similar comprehensive ratification requirements are contained in some U.S. treaties, such as in the French Treaty, Oct. 18, 1946, 64 Stat. 83, T.I.A.S. No. 1982, Arts. 30(1) and (2); the Belgian Treaty, July 9, 1970, 23 U.S.T. 2687, T.I.A.S. No. 7463, Arts. 2(3) and (4); the Japanese Treaty, April 16, 1954, 6 U.S.T. 113, T.I.A.S. No. 3175, 238 U.N.T.S., Arts. 26(4) and (5); and the Iceland Treaty, May 7, 1975, 26 U.S.T. 2004, T.I.A.S. No. 8151, Arts. 29(4) and (5).

10/ U.S.-Canada Treaty, March 4, 1942, 56 Stat. 1399, T.S. 983, 6 Bevans 244, Art. XIX.

11/ Id. Art. XX.

12/ Tax Convention, March 23, 1939, U.S.-Sweden, Art. XVI, 54 Stat. 1759, T.S. No. 958.

13/ Tax Convention, April 29, 1948, U.S.-Netherlands, 62 Stat. 1757, T.I.A.S. No. 1855.

for purposes of information exchange, the taxes covered by the convention are deemed to be the taxes imposed by a contracting state at the national level.14/

Confidentiality of Use of Information Received

Most treaties provide that information exchanged under the treaty shall be treated as secret for stated purposes. Many of the earlier treaties limited disclosure of the information only to persons who were concerned with the assessment and collection of the taxes which are the subject of the convention. The more recent treaties have enlarged these provisions to include courts and administrative bodies involved in enforcement or prosecution.15/

Provisions Allowing a Treaty Partner to Refuse to Exchange Information

Many tax treaties provide that neither contracting state shall be required to carry out administrative measures different from those used by either state in the collection of its taxes or which would be contrary to its sovereignty, security, or public policy.16/

Most U.S. tax treaties state that the requested party either must not or may not exchange information which would disclose any trade, business, industrial, or professional secret or any trade process. Although the Organization for Economic and Cooperative Development (OECD) and U.S. model tax treaties state that the requested state shall not have the obligation to provide such information, many of the treaties in force mandatorily prohibit such exchanges of information.17/

Exchanges of Information in Practice

The information exchanged on a routine basis consists of a much greater volume of material than exchanges in response to specific requests.

The United States receives about 50,000 pieces of information each year from about 19 treaty countries. However, in a recent congressional investigation, it was revealed that those documents received by the IRS were stamped and put in a file and no one has ever looked at them, to the best of the knowledge of the IRS. Better coordination between the Department of Treasury, which negotiates treaties, and the Internal

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14/ U.S. Model Income Tax Treaty, Art. 26, *supra* note 9; U.S. Model Estate and Gift Tax Treaty, Art. 13, reprinted in *8th Ann. Institute on International Taxation* 373-404 (Practicing Law Institute 1977).

15/ Shockey, *supra* note 8, at 9.

16/ *Id.*; *see also* the U.S.-Japan Tax Treaty, *supra* note 9, Art. 26(2), Prentice-Hall Tax Treaties para. 54,056.

17/ *Id.*

Revenue Service, which implements them, has been suggested as a remedy for the nonuse of this material. The IRS is now in the process of reviewing this material and how to use it. The absence of taxpayer identification numbers to which our computers are tied causes problems for the IRS using it.18/

The United States routinely provides computer printouts based on tax Form 1042S or copies of the forms themselves. Form 1042S is an information return filed by U.S. withholding agents identifying income recipients in treaty countries and giving the type and amount of income and the amount of tax withheld.

In addition to the information from Form 1042S, the United States furnishes information concerning coupon-bond interest to treaty partners. Coupon-bond interest is reported on ownership certificates, which are executed in duplicate by the person presenting the coupons for payment. The withholding agent sends both copies of the certificate to the IRS. The certificates are similar to Form 1042S, except that they contain a verification by and the signature of the persons claiming the benefits of the treaty. Copies of these certifications are sent annually to the treaty partners.

Although these information documents are in English, the U.S. treaty partners have not yet informed the United States that language is a problem.

In the congressional oversight hearings into the operations of the Internal Revenue Service in April 1976, a statement was made that it is assumed that the scope of the automatic exchange program will not be expanded beyond its presently existing limits and that it will continue to cover payments of investment and other fixed or determinable annual or periodical-type income.

Discussions have occurred regularly by representatives of the United States, France, Germany and the United Kingdom on implementing tax treaties. These have emphasized designing a uniform information document so the treaty partners (1) can obtain information regarding citizens and residents who receive income from sources within the treaty countries and (2) can receive such information in a form that will be of maximum benefit from a compliance point of view. From the perspective of the United States, this means expecting to receive from its treaty partners only certain basic information concerning the recipient, e.g., name and address; U.S. identification number, if available; the nature and amount of income, the amount of tax withheld, and the year of payment. In addition, the information received must be in a form that is easily extracted from the information document and utilized in a matching system.19/ Another improvement which is being made in the

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18/ Guttentag, Enforcing United States Tax Laws Where the Information or the Taxpayer is Overseas, 12 Int'l. Lawyer 609, 614 (1978).

19/ Oversight Hearings into the Operations of the IRS, Hearing Before a Subcommittee of the House Comm. on Government Operations, 94th Cong., 2d Sess. 115 (April 12, 1976).

routine exchange of information is that magnetic tapes are starting to replace copies of Form 1042S.[20]

Another 200,000 pieces of information are filed by U.S. withholding agents. Since they are on payments made to nontreaty countries, the United States is prohibited by law from sending that information overseas.[21]

The United States annually receives about 150 requests from foreign governments with respect to specific cases. Significant safeguards and restrictions limit the information that the United States and its treaty partners may provide in response to a specific request. Each specific request is considered individually by the IRS to determine whether it is appropriate to comply. The following issues are examined in making the determination: whether it is administratively practical to obtain the information; whether obtaining the information would adequately protect the rights of the persons involved; whether compliance with the request would contravene public policy; and whether the circumstances indicate that the information would be used only by the proper authorities and only for proper purposes in the requesting country. If a request appears intended to be used in the enforcement of exchange control laws rather than tax laws, or for statistical purposes rather than to collect taxes, the United States would not comply with such a request.

Usually, specific requests for information pertain to such matters as determination of residence or citizenship; whether a liability exists for U.S. or foreign tax; financial transactions or ownership of financial or other assets; the control of companies; the source of an item of income; whether a taxpayer is engaged in business in a particular country; and copies of legal or financial documents. In many cases, the taxpayer's own records and third-party information provide the sources of information secured.

If a specific request involves U.S. citizens or corporations, the IRS requires a high degree of specificity to protect such taxpayers' rights. Hence, a request must relate to a particular item of income or expense and a particular taxpayer whose income tax liability is at issue. The requesting state must demonstrate that the person involved is, in fact, subject to its tax laws. In addition, an explanation must be provided as to how the requested information or documents are required for the case and how they are to be used.[22]

20/ Guttentag, _supra_ note 7, at 570.
21/ Guttentag, _supra_ note 18, at 614.
22/ _Id._

Several cases have been litigated in the United States[23/] and in countries such as Switzerland[24/] and the Federal Republic of Germany[25/] in which the right of a requested state to exchange information has been contested. The nuances of these cases are not important for this discussion. It is clear from these cases that, although some courts may give a broad interpretation to treaty provisions, the information must at least be within the purposes if not the express language of the treaty.[26/]

WORKING ARRANGEMENTS FOR TAX TREATIES WHEREBY THE UNITED STATES AND ITS TREATY PARTNERS CONDUCT JOINT AUDITS

In the last 2 years, the United States has entered into working arrangements on two bilateral tax treaties to undertake the simultaneous examinations or joint audits of taxpayers. These arrangements are described to illustrate the trend toward closer cooperation between the United States and its treaty partners in exchanging information.

On June 16, 1977, the United States and Canada agreed to a simultaneous examination program whereby each country separately examines the taxpayers under its jurisdiction. Prior to initiating the audit, the countries meet to plan and coordinate the examination. During each stage of the examination, information is exchanged in accordance with tax treaty provisions. The purpose of the working arrangement is to cooperate in determining income tax liability under the tax laws of each country in the areas of tax avoidance by multinational enterprises.

A multinational enterprise is defined as "one having activities in more than one country with indications of activities in tax havens." In addition, the agreement provides that the specific cases selected for audit should be those where the exchange of information would be beneficial in dealing with tax avoidance.

> Example: X, a U.S. individual, has a 50-percent share in XYZ Company in Canada, which has a subsidiary in the Netherlands Antilles. The subsidiary invests in U.S. income-producing real

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23/ United States v. A.L. Burbank & Co., 525 F.2d 9 (2d Cir. 1975), cert. denied, 96 S.Ct. 2647 (1976); Note, A Tax Treaty Extension of IRS Subpoena Power, U.S. v. Burbank, 8 Law & Policy in Int'l Bus. 1113 (1976).

24/ X v. The Federal Tax Admin., Swiss Federal Supreme Court, CCH Tax Treaties para. 9871 (12-23-70); X & Y Bank v. the Swiss Federal Tax Admin., Swiss Federal Supreme Court, CCH Tax Treaties para. 9765 (1975); see also Kronauer, Information Given for Tax Purposes from Switzerland to Foreign Countries Especially to the United States for the Prevention of Fraud or the Like in Relation to Certain American Taxes, 30 Tax L.Rev. 47 (1974); Meier, Banking Secrecy in Swiss and International Taxation 7 Int'l Lawyer 16 (1973).

25/ See case concerning the German-French Treaty, reported in Business International, May 28, 1976, Vol. XXIII, No. 22, p. 169, and Guttentag, supra note 7, at 572.

26/ Shockey, supra note 8, at 11-12.

estate. The income may or may not be repatriated to Canada. XYZ Company or its affiliates or its shareholders may have other operations which may arouse the suspicions of the Canadian tax authorities. In addition, the accountants used by the XYZ Company also may be notorious for their tax-avoidance schemes, which in Canada can cause an audit.

Since the XYZ Company has both U.S. and Canadian taxpayers as shareholders, and since they, inter alia, have U.S. assets and income and use a tax haven, it is a candidate for a joint audit. Among the issues to be determined by the simultaneous audit will be whether the U.S. and Canadian shareholders are reporting their foreign holdings and income (e.g., the U.S. shareholder would probably have had to file Form 959 and other reporting forms), and whether the income was undeclared, including the use of improper deductions.

Several objectives are set forth in the agreement. The first is to develop guidelines for the exchange of information of multinational enterprises wherein tax haven countries are employed. Another objective is to exchange information on new or apparent patterns or techniques of tax avoidance in each country. In addition, a goal is to develop guidelines for evaluating tax haven transactions resulting, inter alia, from rents and royalties, research and development, and market changes in currency. The working arrangement also is designed to identify payments generally referred to as "under-the-table" payments, such as kickbacks, bribes, and other "illegal" payments.

Administratively, the formal exchange of information will originate from the Office of International Operations of the IRS in the United States or the Provincial and International Relations Division of the Department of National Revenue, Taxation, in Canada. A request is directed to the designated competent authority of the other country. The information which may be requested must be obtainable under the revenue laws of both countries and must relate to an income tax matter of at least one country.

In implementing the arrangement, the National Office of the IRS and the Head Office of the Department of National Revenue, Taxation will jointly identify for simultaneous audits appropriate multinational enterprises. After selecting cases for simultaneous audits, the case managers from each country will meet, along with their respective assistants, to discuss a timetable for examinations, entities to be examined, and approaches to be taken in view of the objectives. Interim information and tentative conclusions will be exchanged by the individual case managers from the audit teams to assist the other country's team in the completion of its audit. After the audits have been completed, information will again be exchanged so that final action can be recommended with respect to the examinations in each country. Ordinarily, final action will not be taken until both countries have completed their examinations. No actual interchange of audit personnel will take place between the two countries.

After the initial cases are concluded, representatives of the respective tax authorities will meet to assess the effectiveness and benefits from the simultaneous examination program. At this time, recommendations can be made to amend or improve the working arrangement.27/

On March 2, 1978, the United States and the United Kingdom signed a formal working arrangement providing for the simultaneous examination of taxpayers. This was the second such agreement for the United States.28/ The United Kingdom also has signed similar agreements with some of its EEC partners, such as France and the Federal Republic of Germany, and is actively seeking to conclude more.

LEGISLATION AUTHORIZING SOCIAL SECURITY TOTALIZATION AGREEMENTS

In 1977, the U.S. Congress enacted legislation authorizing the President to enter into agreements establishing totalization arrangements between the social security system established under U.S. law and the social security system of any foreign country, to establish entitlement to and the amount of old-age, survivors, disability, or derivative benefits based on a combination of an individual's periods of coverage under the social security system in the United States and that of a foreign country.29/

The legislation is significant, not so much for its substantive provisions, but rather for the procedure needed to put these agreements into effect.

After entering into an agreement, the President must transmit the agreement to Congress, together with a report on the number of individuals who will be affected by the agreement and the effect of the agreement on the estimated income and expenditures of the U.S. social security programs.30/

An agreement becomes effective on a date provided in the agreement. Such a date must follow the period after which the agreement has been transmitted to Congress and during which each House of Congress has been in session for 90 days and during which time neither House has adopted a resolution disapproving the agreement.

27/ I.R.S. Manual Supplement, Working Arrangement Between the United States Internal Revenue Service and the Department of National Revenue-Taxation Under the Terms of the Canada-U.S. Reciprocal Tax Convention, (Attachment 1 to MS 42G-371, CR 12G187) also set forth in 9th Ann. Institute on International Taxation 565 (Practicing Law Institute, 1978).

28/ I.R.S., News Release of March 2, 1978 (unpublished).

29/ 42 U.S.C. sec. 433(a).

30/ 42 U.S.C. sec. 433(e)(1).

This procedure has been advocated as a means whereby executive agreements for minibilateral tax agreements can be concluded and put into force. These miniagreements would provide for the exchange of information.

TREATIES OF MUTUAL ASSISTANCE IN CRIMINAL MATTERS

The United States has in force bilateral agreements to assist other countries in enforcing criminal laws. Two types of these agreements have significance in the exchange of information. An example of the first type is the Mutual Assistance Treaty between the United States and Switzerland, which provides, inter alia, for the exchange of information, documents, or the providing of judicial assistance. An example of the second type is the series of executive agreements the United States has with foreign governments involving international "slush fund" payments. These agreements are mentioned because they recently have been concluded and because they provide models of exchanging information.

Before considering these agreements, a preliminary comment on international law background is useful. In international criminal law, a distinction is made between international judicial assistance, also referred to as international judicial cooperation, and international executive assistance. The former is defined as "aid rendered by one nation to another in support of judicial or quasi-judicial proceedings in the recipient's tribunals."[31/] It should be distinguished from official assistance, which refers to international cooperation among the executive branches of government outside the sphere of the court process.[32/]

International judicial assistance embraces the following: interrogations; delivery of property; search and seizure; local inspection; service of documents; summons; transfer of persons in custody for the purpose of giving evidence as a witness or for the purpose of confrontation; search and identification; information; supervision of conditionally sentenced or conditionally released offenders; assumption of prosecution; and enforcement of foreign criminal proceedings.[33/]

Requests for information often are made in the framework of international judicial assistance. A request for information is treated as a request for judicial assistance if such information is to be used to promote the investigation and prosecution of a criminal offense. In such a case, the authorities requested to furnish information must comply with the contractual and statutory provisions on judicial assistance.

31/ Jones, International Judicial Assistance: Procedural Chaos and a Program for Reform, 62 Yale L.J. 515 (1953).

32/ Mueller, International Judicial Assistance in Criminal Matters, 7 Villanova L.Rev. 193, 196 (1961-62).

33/ Grutzner, International Judicial Assistance and Cooperation in Criminal Matters, in 2 A Treatise in International Criminal Law 202-18 (M. Bassiouni & V. Nanda eds. 1973).

Recent treaties such as the European Convention on Mutual Assistance in Criminal Matters[34] have, in connection with regulating the furnishing of information from the judicial records for the purposes of criminal law, covered the providing of such information for noncriminal law purposes.[35]

The trend toward cooperating in criminal matters is recent. In 1961, Dr. Gerhard O. Mueller, a distinguished scholar in this legal field, wrote "despite the growing need for mutual asistance among the judiciaries of the world, it appears that the American courts neither give nor receive (nor ask for) adequate judicial assistance in criminal matters, American treaties on the topic being non-existent and statutory provisions scarce."[36]

Until 1948, the law in the United States regulating judicial assistance in criminal matters progressed more slowly than that dealing with such assistance in civil matters. In 1928, the United States joined with the United Kingdom and the British Commonwealth to block the conclusion of a multilateral agreement on judicial assistance, which a committee of experts appointed by the League of Nations for the codification of international law had drafted. Then, starting in 1949, the United States took action, extending section 1782 of the Federal Judicial Code to include criminal matters.[37] The law in New York[38] and New Jersey[39] also provided for the interrogation of witnesses in criminal matters on behalf of foreign tribunals. Several states adopted the Uniform Foreign Deposition Act, providing for the interrogation of witnesses in criminal matters. On October 3, 1964, the Federal Law for the Improvement of Judicial Procedure for the Service of Documents, Obtaining of Evidence and Proof of Documents in Litigation with International Aspects was enacted, amending the provisions relating to judicial assistance contained in Title 18 and especially in Title 28 of the U.S. Code.[40]

The U.S. Treaty of Mutual Assistance in Criminal Matters with Switzerland, signed May 25, 1973, which entered into force in January 1977, is

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34/ Council of Europe, European Convention on Mutual Assistance in Criminal Matters, signed Dec. 13, 1957, Art. 13, para. 1 (obtained from Directorate of Legal Affairs, Council of Europe, Strasbourg, France); Council of Europe, Explanatory Report on the European Convention on Mutual Assistance in Criminal Matters (Strasbourg, 1969); European Committee on Crime Problem, Problems Arising from the Practical Application of the European Convention on Mutual Assistance in Criminal Matters (Strasbourg, Council of Europe 1971).

35/ Grutzner, supra note 33, at 214-15.

36/ Id. at 197.

37/ Id. at 201.

38/ Sec. 310 New York Civil Practice Act.

39/ New Jersey Criminal Rules 2, 5-6.

40/ Law for the Improvement of Judicial Procedure for the Service of Documents, Obtaining of Evidence and Proof of Documents in Litigation with International Aspects of 1964. Pub. L. No. 88-619, 78 Stat. 996 (amending 28 U.S.C. sec. 1696).

the only comprehensive mutual assistance treaty which the United States has in force.41/

The Treaty requires mutual asistance with respect to the investigation and prosecution of 35 enumerated crimes. Articles 6 to 8 of the Treaty concern organized crime. The requesting state must have probable cause to believe that a person is involved in organized criminal activity and must be unable to prosecute the suspect without the requested information. The requested state reserves the right to satisfy itself that both conditions have been fulfilled.

The Treaty allows the requested state to maintain strict control over the uses to which the requesting state may put any information received through a specific request. In this connection, use of the information in a proceeding relating to another offense or investigation in the requesting state is forbidden.

The Treaty expressly excludes its application to involuntary extraditions, enforcement of criminal judgments rendered in another state, political offenses, antitrust or cartel violations, and custom or tax violations that are not committed in the furtherance of organized criminal purposes.

In other areas, a requested state may refuse assistance if its own sovereignty, national security, or similar interests would be compromised, or if the subject of the request is not involved in organized crime and has been acquitted or convicted in the requesting state for a substantially similar offense.42/

Apparently the U.S. Department of Justice has been satisfied with the operation of the Treaty.43/ The United States also is trying to negotiate similar treaties with Mexico and Turkey.44/

The more often-used mechanism by which the United States has exchanged information is through its series of executive agreements with foreign governments involving international "slush-fund" payments. The United States has made 35 such agreements with 23 different countries since 1976.

These agreements usually state in the text that they are limited to use for the purposes of the investigation of the matter (e.g., the "slush-fund" payments pertaining to corporations mentioned in the agreement), and in ensuing criminal, civil, and administrative proceedings. The agreements provide that all requests for assistance are to be communicated between the parties through diplomatic channels.

41/ Treaty on Material Assistance in Criminal Matters, January 23, 1977, U.S.-Switzerland, 27 U.S.T. 2019, T.I.A.S. No. 8302.

42/ Id.

43/ Hearings on Offshore Tax Havens, supra note 1 (statement by D. Rosenbloom, International Tax Counsel, at 15).

44/ Id. (statement by H. Dale, at 12).

The agreements provide that, upon request, the parties shall use their best efforts to provide to each other relevant and material information, such as statements, depositions, documents, business records, correspondence, or other materials available to them concerning alleged illicit acts pertaining to the activities specified in the agreement.[45]

The agreements also expressly provide that all information made available by the parties under the agreement and all correspondence between the parties relating to such information and to the implementation of the agreement must be kept confidential and must not be disclosed to third parties or to government agencies having no law-enforcement responsibilities. Disclosure to other agencies with law-enforcement responsibilities can take place only if the recipient agency accepts the terms of the agreement. In the event a subsequent change in the domestic law of a party makes difficult the implementation of the terms of the agreement, the requesting state must promptly return all the materials made available. If the confidentiality of the agreement is breached by one party, the other party may discontinue cooperation under the agreement.

These agreements have significance since they demonstrate the willingness of the United States and many other countries to exchange information about international business transactions when they have important interests at stake. However, important aspects of the agreements are the limitation of their use solely to the illicit matters specified, by law enforcement agencies only, and the requirement that the information disclosed be kept confidential. Whether the United States and other countries are willing to extend the use of such new mechanisms to such matters as direct foreign investment is questionable.

MULTILATERAL EUROPEAN AGREEMENTS

This section considers existing and proposed agreements in Western Europe relating to the exchange of information. In particular, three of them are examined: a proposed directive of the European Economic Community to exchange statistics on capital movement from third countries to EEC member states; a directive now in force concerning mutual assistance by the competent authorities of member states in the field of direct taxation; and the European Convention for Mutual Assistance in Criminal Matters.

45/ See, e.g., Procedures for Mutual Assistance between the U.S. and Colombia in the Administration of Justice in Connection with the Lockheed Aircraft Corporation Matter, Art. 2, April 20, 1976, T.I.A.S. No. 8244, 27 U.S.T. 1059.

Proposed EEC Council Directive on Exchange of Statistics Pertaining to Capital Movements

On October 27, 1965, the proposed EEC Council Directive on Exchange of Statistics pertaining to Capital Movements was issued.[46] The proposed directive, although addressed to cover investments from third countries into the member states of the EEC, was intended mainly to obtain better knowledge of American investments into the EEC.

The EEC directive proposed a two-fold procedure. First, member states were to undertake to submit regularly to the EEC Council comparable statistics on movements of capital in third countries.[47] Second, consultations (every 6 months or annually) were to be held between the member states, within the EEC Council, on investments by third countries into the member states and the policies to be followed in this respect.[48]

The proposal caused some reservations, and some national delegations feared that the fact of submitting U.S. investments to strict statistical control might discourage some initiative and result in an atmosphere of wariness. Some member states indicated that they were not in a position to provide the facts and figures in question in the way in which the proposal and the EEC Council reports suggested they should be categorized (e.g., by economic sector, by region, etc.).

In July 1967, the EEC Council established an *ad hoc* group of "national experts on capital movement statistics" to study the technical difficulties and concrete possibilities of overcoming them. Due to delays in submitting the necessary information and to delays in replying to the questionnaire sent to national administrators, the report was 13 months late. The report analyzes the statistical methods used in the various member states and reveals why these rules are not always fully applied. Differences exist between the countries on the way overall figures are broken down, the ways of calculating them, and how facts and figures are presented. According to the report, the statistics cannot really be compared--partly due to the present gaps in information available, particularly because the extent of knowledge of investments is not the same in all the member states (e.g., reinvested profits are not systematically noted everywhere).

The report sets forth problems and possible solutions. One of the principal aspects of the proposal, the categorizing of direct foreign investment by economic sector and regions, was not welcomed. Two delegations (France and Italy) accepted, with some reservations, the draft table on this matter, but the German and Benelux delegations opposed it, in view of the technical difficulties and because their countries are not divided into "economic regions," or because these same economic regions do not coincide with their internal political subdivisions.

46/ Proposed Council Directive for the Communication to the Commisson of Certain Statistics Concerning the Movement of Capital to Member Countries from Third Countries, COM(65)409, Brussels, Oct. 27, 1965.

47/ *Id.* Art. 2.

48/ *Id.* Art. 4.

The report's conclusion is not encouraging and states that obstacles, particularly statistical, economic and legal ones, stand in the way of the realization of the final aim, which is to complete, clarify, and make more comparable the facts and figures on movements of capital.

Since the report, the proposed directive has remained dormant. It does serve, nevertheless, as one model which can be utilized if the United States and other countries decide they want to conclude an agreement to exchange statistics on foreign direct investment.

EEC Directive on Common Action to Combat Tax Evasion and Tax Avoidance

On January 1, 1979, an EEC Directive on Common Action to Combat Tax Evasion and Tax Avoidance, adopted by the Finance Ministers of the Community, took effect.49/ The Directive is designed to eliminate tax evasion and tax avoidance, which distort capital movement and competition, through supplementing intergovernmental cooperation in bilateral tax treaties. This Directive enables the Finance Ministers to request information from each other to correctly assess taxes on income and capital.

The new legislation goes considerably further than the basic bilateral tax treaty agreements (see the earlier discussion on working arrangements) currently in existence between them:

1. The requests for information are not limited to defined areas, but cover "any information that may enable them to effect a correct assessment of taxes on income and capital."50/

2. The Directive also provides for "spontaneous exchange of information," whereby the competent authority of a member state shall "without prior request" communicate information in the following cases:

-- The competent authority of a member state has grounds for supposing that there may be an abnormal reduction in tax or liability to tax in the other member state;

-- A person liable to tax obtains a reduction in or exemption from tax in the one member state which will give rise to an increase in tax or to liability to tax in the other member state;

-- Business dealings between a person liable to tax in one member state and a person liable to tax in another member state involving a fixed establishment of such persons or one or more third parties in one or more countries are likely to result in a saving in one of the member states or in both;

49/ Council Directive of Dec. 19, 1977, concerning mutual assistance by competent authorities of the Member States in the field of direct taxation. Official Journal of the European Commun., No. L336/15; Dec. 27, 1977 (77/799/EEC).

50/ *Id.* Art. 1.

-- The competent authority of a member state has grounds for supposing that a saving of tax may result from artificial transfer of profits within groups of undertakings;

-- Information transmitted to one member state by the competent authority of another member state has enabled information to be obtained which may be relevant in assessing liability to tax in the latter member state.[51]

3. Finally, unlike bilateral or multilateral conventions, the Directive has a legal basis, whereby a party can be brought before the European Court of Justice if it fails to fulfill the obligations contained in the legislation.[52]

The scope of the Directive is limited. It covers only direct taxation, which is defined as "all taxes imposed on total income, on total capital; or on elements of income or capital, including taxes on gains from the disposal of movable or immovable property." Another limitation is that exchange of information may be refused where it would lead to the disclosure of commercial, industrial, or professional secrets or of a commercial process or of information whose disclosure would conflict with public policy.[53]

The Directive provides that, for categories of cases which they shall determine under the consultation procedure in the Directive, the competent authority of the member states shall regularly exchange the information within the scope of the treaty without prior request.[54]

In the Directive, the member states and the EEC Council have agreed to pool their experience with "a view to improving such cooperation and, where appropriate, drawing up rules in the fields concerned."[55]

The main significance of the Directive is that it indicates the willingness of EEC member states to cooperate more closely in exchanging information to combat tax evasion and tax avoidance. The directive also shows that member states are trying innovative mechanisms (e.g., spontaneous exchanges of information by which to solve problems arising from international business transactions). In addition, the regular consultations and the ability of member states to resort to the European Court of Justice to resolve any difficulties which may arise from the implementation of the Directive give it an institutional and legal basis unique to these exchange of information arrangements.

51/ Id. Art. 3.

52/ Contents of European Commission Proposal Concerning Common Action by the "Nine" in Combating International Tax Evasion and Avoidance, in Agence Europe (Brussels), April 16, 1976, No. 1964, at 7.

53/ Council Directive of Dec. 19, 1977, supra note 49, Art. 8.

54/ Id. Art. 3.

55/ Id. Art. 10.

The European Convention on Mutual Assistance in Criminal Matters

The European Convention on Mutual Assistance in Criminal Matters was drafted by the Council of Europe. It was signed by the 17 members of the Council on Decemebr 3, 1957, and has been ratified by at least 9 member countries. Three nonmembers have acceded to it.56/

The Convention provides for the following types of assistance: service of writs and records of judicial verdicts; appearance of witnesses, experts, and prosecuted persons; transmission of judicial records; and the exchange of information relating to criminal convictions and subsequent measures concerning nationals of another party to the treaty.

The Convention provides that one party through its Ministry of Justice can request assistance from another party through sending letters rogatory to the requested party's Ministry of Justice.57/ Requests for mutual assistance must state: the authority making the request; the object of and the reason for the request; where possible, the identity and nationality of the persons concerned; and where necessary, the name and address of the person(s) to be served.58/

The Convention does not apply to arrests or the enforcement of verdicts or offenses under military law which are not offenses under ordinary criminal law. A requested state may refuse assistance if the request concerns an offense which the requested country considers a political offense, an offense likely to prejudice the sovereignty, security, public order, or other essential interests of its country.59/

Upon signing the Convention or depositing its instrument of ratification or accession, a contracting party may by declaration reserve the right to make the execution of letters rogatory for search or seizure of property dependent on one or more of the following conditions: that the offense for which the letters rogatory are sought is punishable under both the law of the requesting state and the law of the requested state; that the offense for which the letters rogatory are sought is an extraditable offense in the requested country; and that execution of the letters rogatory is consistent with the law of the requested state.

The limitations contained in the European Convention of Mutual Assistance in Criminal Matters are much narrower than its U.S.-Switzerland counterpart.

Conventions on mutual assistance in criminal matters could be adjusted to include, as in the case of the European Convention on Mutual Assistance in Criminal Matters, subjects other than those relating to criminal law. In addition, they could be drafted to include criminal offenses,

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56/ *Supra* note 34.
57/ Council Directive of Dec. 19, 1977, *supra* note 49, Art. 15.
58/ *Id.* Art. 14.
59/ *Id.* Art. 2.

such as tax evasion and currency violations, related to transnational investments.

OTHER MULTILATERAL APPROACHES

Several other multilateral approaches have considered the exchange of information and the facilitation of better disclosure. The Organization for Economic Cooperation and Development (OECD) has issued guidelines on disclosure. At least two United Nations groups have been studying the problem. This section considers these multilateral approaches and their significance for potential U.S. cooperation.

The OECD Declaration on International Investment and Multinational Enterprises

In the earlier chapter on legislation and activities in foreign countries, the background and framework of the OECD is described. In addition, the adoption by the OECD of a Code of Liberalization of Capital Movements--whereby member countries agree to progressively eliminate restrictions on capital movements and try to refrain from introducing new restrictions on capital movements or make existing regulations more restrictive--was highlighted.

The same earlier chapter also discussses the OECD Declaration on International Investment and Multinational Enterprises[60/] under which OECD members are to accord to foreign-controlled enterprises operating in their territory treatment--under their laws, regulations, and administrative practices--consistent with international law and no less favorable than that accorded in like situations to domestic enterprises.

Most important to the discussion in this section is the OECD Declaration's annex which provides guidelines for multinational enterprises. The guidelines are intended to encourage the positive contributions which multinational enterprises can make to economic and social progress and to minimize and resolve difficulties which their various operations may produce. Observance of the guidelines is voluntary and not legally enforceable. OECD members have agreed to establish review and consultation procedures concerning issues arising in respect to their guidelines.

The guidelines require in particular that multinational enterprises must observe legal obligations concerning information. The guidelines further require multinational enterprises to supply their entities with supplementary information which the latter may require to meet requests by the authorities of the countries in which those entities are situated for information relevant to the activities of those entities, taking into account legitimate requirements of business confidentiality.

A subheading of the guidelines addresses disclosure of information. It states that enterprises should, taking into consideration their nature

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60/ 15 Int'l Leg. Mat. 967.

and relative size in the economic context of their operations, and the requirements of business confidentiality and cost, publish in a manner understandable to the public adequate factual information on the structure, activities, and policies of the enterprise as a whole to supplement the information disclosed under the national law of the individual countries in which an affiliate operates. Accordingly, they should publish on a regular basis or at least annually financial statements and other information relating to the enterprise as a whole. In particular, the guidelines provide for disclosure of the following:

1. The structure of the enterprise, indicating the name and location of the parent company, its main affiliates, its percentage ownership, direct and indirect, in its affiliates, including shareholdings between them;

2. The geographical locations where operations are carried out and the principal activities carried on therein by the parent company and the principal affiliates;

3. The status of operations and sales by geographical area and the sales in the major lines of business for the enterprise as a whole;

4. Significant new capital investment by geographical area, and, as far as practicable, by major lines of business for the enterprise as a whole;

5. Information as to the sources and uses of funds by the enterprise as a whole; and

6. The accounting policies, including those concerning consolidation.

Other International Developments

Several other multilateral approaches show a trend toward governments requiring more relevant and comparable financial information on the operations of multinational enterprises. Included are activities by such diverse groups as the International Accounting Standards Committee,[61/] the U.N. Commission on Transnational Corporations,[62/] the European Communities,[63/] and various regulatory and standard-setting bodies in a number of countries. However, it appears that in the immediate short

61/ See Evans & Leddy, Can American Accountants Serve Two Masters: FASB and IASC?, 46 J. Certified Public Accountants 6-7 (Jan., 1976).

62/ For the establishment of the U.N. Commission on Transnational Corporations, see U.N. Econ. and Soc. Council (ECOSOC), ECOSOC Resol. 1913, 57 UN.ESCOR, Supp. U [No. 1A0, U.N. Doc. E/5570/Add. 1 (1975)]; see also Rubin, Harmonization of Rules: Perspective on the U.N. Commission on Transnational Corporations, 8 Law and Policy Int'l Bus. 875 (1976).

63/ See generally, EEC, Tenth General Report of the Activities of the European Communities (1976); M. Oldman, Accounting Systems and Practices in the EEC passim (1975).

term a unified approach will be difficult to achieve due to the substantial differences in accounting and reporting from country to country and the diversity of interests among governments wanting to use financial reports. The differing laws, customs, taxation policies, and protection given to business and trade secrets all make harmonization of disclosure and accounting practices difficult.

More vigorous exchange of information pursuant to bilateral tax treaties has been discussed by the U.N. Group of Experts on Tax Treaties Between Developed and Developing Countries.[64/] If the developing countries are going to be able to effectively start taxing income at the source, they need more information on items such as pricing, deductions claimed due to payments to entities (often affiliates) in other countries, etc. Since developing countries have limited resources to gather and verify information and since developed countries have substantially more resources which are devoted to obtaining such information, the developing countries would be benefitted by increased international cooperation and particularly the exchange of information. Some of the recent reports of the U.N. Group of Experts on Tax Treaties Between Developed and Developing Countries have provided an inventory of useful information which should be exchanged.

Two caveats should be mentioned, however, with respect to increased cooperation in exchanges of information between the United States and developing countries. First, developing countries which provide services as tax havens may not want to exchange information because the loss of business due to absence of confidentiality may outweigh the potential benefits of exchanging information, unless the United States and/or other countries or organizations offer extrinsic incentives. Second, developing countries in general view the U.S. policy in negotiating tax treaties as inflexible and unfairly harsh vis-a-vis developing countries. The United States has not been successful, compared with other developed countries, in negotiating treaties with developing countries. In addition, in several cases, treaties were signed but not ratified when the U.S. Senate refused to ratify concessions (e.g., known as tax-sparing provisions) given by the United States in treaty negotiations.

In considering other multilateral approaches to exchanging information and facilitating disclosure, it is clear that concrete regulations and agreements cannot be identified. However, increased concern by countries is being shown, and guidelines, albeit only voluntary, have been issued.

INTERACTION BETWEEN EXCHANGE OF INFORMATION UNDER INTERNATIONAL CONVENTIONS AND LIMITATIONS CONTAINED IN U.S. DOMESTIC LAW

In this section, the interaction between exchange of information under international conventions and limitations contained in U.S. domestic

64/ See Surrey, United Nations Group of Experts and Guidelines for Tax Treaties Between Developed and Developing Countries, 19 Harvard Int'l L.J. 1, 101, 190-204 (1978).

law is discussed. With the exception of the limitations in the use of tax laws, the other U.S. laws are discussed in other chapters of this study.

As the section of this chapter on working arrangements for tax treaties notes, Section 6103(k)(4) of the Internal Revenue Code provides that "a return or return information may be disclosed to a competent authority of a foreign government which has an income tax or gift and estate tax convention or other convention relating to the exchange of tax information with the United States, but only to the extent provided in, and subject to the terms and conditions of such convention."

This section discusses in more detail the confidentiality provisions resulting from the amendments of the Tax Reform Act of 1976.65/

Before the Tax Reform Act of 1976, the Internal Revnue Code provided that tax returns were public records, although they were open to inspection only in accordance with regulations approved by the President or under Presidential order.66/ However, Section 1202 of the Tax Reform Act of 1976 provides that tax returns as well as return information are confidential and can be disclosed only in specific cases set forth in that section.67/

The section defines "return" as any tax information return, declaration of estimated tax, or claim for return, together with any amendment or attachment filed therewith.68/ "Return information" is broadly defined to embrace a taxpayer's identity, the source or amount of a taxpayer's income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessements, and tax payments, together with any information received by, recorded by, furnished to, prepared by, or collected by the Internal Revenue Service concerning a return or the issue of the existence, or possible existence of tax liability or a summary of any of the aforementioned items.69/ "Taxpayer return information" is defined as information which is filed with or furnished to the IRS by or on behalf of the taxpayer. "Disclosure" means making known to any person in any manner whatever a return or return information.

Disclosure of returns or return information in any manner may occur only in specifically enumerated areas, as follows: disclosure may be made by the IRS, upon written request, to the taxpayer who filed the return, or his or her designated representative, a spouse filing a joint return, partners of a partnership, executors, trustees, heirs or beneficiaries of a trust, the holder of 1 percent or more interest of a corporation's return, and other designated persons.70/

65/ See the excellent article on this subject by Parnell, The Right to Privacy and the Administration of the Federal Tax Laws, 31 Tax Lawyer 113 (1977).
66/ I.R.C. sec. 6103.
67/ Id. sec. 6103(a).
68/ Id. sec. 6103(b)(1).
69/ Id. sec. 6103(b)(2).
70/ Id. sec. 6103(d).

Disclosure also may be made to certain designated government officials. Disclosure may be made, upon written request, to the House Committee on Ways and Means, the Senate Committee on Finance, the Joint Committee on Taxation, their respective designated staff members, and the Chief of Staff of the Joint Committee on Taxation.[71] In addition, upon the President's request, the President and employees of the White House specified in the request, may obtain returns and return information.[72] Disclosure can be made, without written request, to Department of Treasury officers and employees whose duties require them to examine such records.[73] Disclosure of various items, such as income, estate, gift, social security, self-employment and withholding and return information is permitted by the IRS to State tax officials for the purpose of administration of tax laws.[74]

Disclosure of return and return information is permitted with respect to a taxpayer whose civil or criminal tax liability is in question. Disclosure of such information also is permitted to attorneys of the Tax Division of the Justice Department, if the item on the third party's return possibly relates to a transaction between the third party and taxpayer which is relevant to determining an issue of the taxpayer's liability.[75] Disclosure of a taxpayer's or third party's return or return information also may be made in judicial and administrative tax proceedings under the same circumstances as such data may be disclosed to Justice Department attorneys.[76]

Disclosure to a Federal agency of returns or taxpayer return information may be made in conducting nontax criminal investigations only when a district court judge issues an _ex parte_ order after determining that reasonable cause exists to believe that a specific criminal act has been committed, that the information disclosed is probative of an issue related to the commission of a criminal act, and that the information requested cannot be obtained reasonably from any other source or is the most probative evidence. Furthermore, if the Justice Department or a Federal agency wants to introduce returns, return information, or taxpayer return information into evidence in court or in an administrative hearing, a judge or hearing officer must determine that such information would be probative of an issue related to the commission of the criminal act.[77] In eight other instances related to tax or criminal law administration, disclosure is permitted under Section 6103.[78]

Individuals who violate the disclosure provisions are subject to both criminal prosecutions and civil actions. Section 7213 of the Internal Revenue Code provides that an individual convicted of violating the

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71/ _Id._ sec. 6103(f).
72/ _Id._ sec. 6103(g).
73/ _Id._ sec. 6103(h)(1).
74/ _Id._ sec. 6103(d).
75/ _Id._ secs. 6103(h)(2)(B) and (C).
76/ _Id._ sec. 6103(h)(5).
77/ _Id._ sec. 6103(i)(4).
78/ _Id._ secs. 6103(k)(6) and (j).

disclosure laws is guilty of a felony and punishable by a fine of not more than $5,000 or imprisonment of not more than 5 years or both. In addition, under new Section 7217, if any person knowingly or by reason of negligence makes an unlawful disclosure of a return or return information, a taxpayer may bring a civil suit and may obtain both actual as well as punitive damages, and in no case will recovery be less than $1,000 for each unauthorized disclosure.79/

The new antidisclosure provisions, together with provisions in U.S. tax treaties, prevent disclosure to other government agencies of information exchanged under tax treaties. They also indicate a trend in the U.S. Congress to look unfavorably upon disclosure of the aforementioned information.

Additional legal issues that may arise would depend on the mechanism the United States would use to obtain the information exchanged. Presumably the U.S. Government would select one of the four scenarios with which this report has dealt.

As the chapter on the feasibility of systems to register and report foreign ownership indicates, in Scenario I, requiring disclosure of individual real estate parcels and owner information would first require the enactment of legislation specifically authorizing direct registration. However, if the mechanisms used are limited to measuring total magnitudes and to state locations of foreign investments, the existing authority of the Bureau of Economic Analysis (BEA) can be used for the release of aggregate data.

The same chapter relates, in Scenario II, that the use of current Federal agency data sources with some modifications to monitor foreign investment in U.S. real estate would require new legislation, *inter alia*, to obtain more transactions. In addition, the confidentiality provisions pertaining to BEA and to IRS material must be changed to reveal the total size (in terms of acres) and value (book value) of the existing real estate holdings of foreign investors reporting. Legislation also is needed if adminstration and analyses of the multiagency collection are to be centralized.

Scenarios III and IV, the establishment of a multipurpose land-data system (MPLDS) to monitor direct investment in U.S. real estate, would require more disclosure of information by foreign investors than that required of them in Scenarios I and II. The legal issues raised by using these scenarios are discussed in the chapter on legal issues pertaining to MPLDS.

The President is authorized by Article II, Section 2 of the U.S. Constitution, by and with the advice and consent of the Senate, to make treaties with foreign nations. Although the Constitution is silent on other forms of international agreements, the President has commonly entered into various forms of agreement with foreign countries which,

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79/ *Id.* sec. 7217.

while they fall short of treaties in that they do not comply with the prescribed constitutional methods for the conclusion of treaties, have nevertheless been held valid and binding.

SUMMARY AND CONCLUSIONS--POTENTIAL USES FOR INTERGOVERNMENTAL EXCHANGES OF INFORMATION

Depending on the objectives of the U.S. Government and its treaty partners and the mechanisms which are employed, intergovernmental exchange of information can serve two principal objectives. The first can be to help solve the layering problem. The second can be to obtain better statistical information on both inbound and outbound foreign investment. This section first considers exchanging information, particularly through bilateral conventions, to help solve the layering problem. Next, this section considers the second principal objective of obtaining statistical information, particularly the use of multilateral mechanisms to accomplish both objectives.

The Extent to Which Exchange of Information Can Help Solve the Layering Problem

An issue which has arisen, particularly in the context of the implementation of the Agricultural Foreign Investment Disclosure Act of 1978, is whether the layering problem can be solved. The layering problem occurs when foreign investors use one and often more layers or tiers by which to structure their investments in U.S. real estate. In most cases, the layers consist of entities based in no- or low-tax jurisdictions, referred to as tax havens, which have laws requiring, often under penalty of criminal law, that holdings in such entities be kept anonymous. The use of layers oft n precludes the U.S. Government from ascertaining the source country of the investment. This section considers the issue of whether exchange of information under international conventions, when used either alone or in conjunction with other mechanisms, can effectively solve the layering problem. First, the types and locations of entities employed and the reasons for their use are discussed. Then the possible means by which the United States can solve the layering problem are considered.

The types and locations of layers employed and even the reasons for their use are diverse. Foreign investors have several legitimate reasons for using layering mechanisms.

The most common entities for acquiring and holding U.S. real estate investments are those based in either the Netherlands Antilles or the British Virgin Islands. These entities can take advantage of existing

tax treaties with the United States to minimize the tax consequences on their annual income and gains upon disposition of their investments.80/

In many cases, still other layers may be used. For instance, the wealthy European often uses a family foundation, such as the anstalt (establishment) and the stiftung (foundation) in Liechtenstein.81/ Civil law trusts also can be created in several havens such as Liechtenstein, Switzerland, the Netherlands Antilles, and Panama. Foreign trusts are utilized by individuals undertaking international business transactions for the flexibility offered by trusts since one trust can be used to participate in several types of investments in various countries.82/ A trust also has continuity and often is used as an effective estate-planning mechanism. In addition, the trust may be able to insulate the trust property against claims of creditors. The use of a trust also permits easy movement of the situs of the trust for administration and interpretation purposes. The confiscation of private property, which investors have experienced due to wars, political revolutions, and other reasons, has influenced investors to use foreign trusts in structuring their investments.

Another commonly used mechanism by which to maintain the anonymity of an investment is investing through bearer shares. Although they are not used in the United States, they are common in Europe and much of the world. Bearer shares belong to the person who has possession of them. Possession and ownership can be transferred from one person to another, merely by delivery and without notice to the company.

Bearer share certificates usually have numbered coupons attached to them. These coupons are used to pay dividends just as bond coupons are used to pay interest. However, unlike the coupons attached to bonds, these coupons do not mature at specified times or in specified amounts. Each share coupon becomes validated and may be presented only by the declaration of a dividend and in the amount declared. Dividend declarations of corporations which have issued bearer shares usually state a specified amount per share shall be payable against presentation of, for example, coupon 3. Each share certificate comes with a set of numbered coupons and with a talon, which entitles the holder to receive a new set of coupons after the first set is depleted. The corporation's first dividend declaration validates coupon 1; the second validates coupon 2, etc. If the owner of bearer shares loses physical possession of the share certificates, he or she cannot collect any dividends.

To qualify to vote, the holder of bearer shares must deposit his or her stock certificates. All European civil law corporation laws provide, as

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80/ See, e.g., Langer, Europeans Investing in U.S. Real Estate Through Netherlands Antilles and the British Virgin Islands Corporations, in N.Y.U. 6th Ann. Int'l Instit. on Tax and Business Planning (1978); and Zagaris, Investment by Nonresident Aliens in United States Real Estate, 31 U. of Miami L.Rev. 565-613 (1977).

81/ See Zagaris, supra note 80, at 607-08.

82/ For advantages of foreign trusts, see generally Foreign Trusts in International Planning (Practicing Law Institute, 1974); M. Langer, How to Use Foreign Tax Havens 80-95 (Practicing Law Institute, 1975).

a prerequisite to the exercise of the right to vote such shares, that before or during the stockholders' meeting, the stock certificates be deposited with the corporation or with a bank, with such deposit being in the name of the person who personally or by proxy will vote the shares represented by such stock certificates.83/

Another issue relevant to the U.S. Government's potential desire to ascertain information on the upper layers of a foreign investor in U.S. real estate is whether it can ascertain from the public record the names of the incorporators and other pertinent information, such as the residence or domicile of the incorporators. Most countries require that information about the incorporators, directors, and officers be set forth in a notarial document which must be filed with a registrar of companies or its counterpart in common law countries. In many countries, various incorporation documents containing the names of the incorporators, directors, and officers, and information about share capital, must be published in an official gazette. However, a foreign investor wanting to maintain anonymity usually will use local nominee incoporators and their names will appear in the public documents and publications.84/

Another means whereby an investor may try to keep his anonymity is by using a numbered bank account. Bank secrecy laws in a country such as Switzerland, which makes available numbered accounts, forbid the disclosure of a bank secret. These laws provide for imprisonment of up to 6 months or a fine of up to SwF 50,000 as the penalty for anyone who discloses a bank secret or tries to induce someone else to do so. It applies to bank officials, employees and agents, bank auditors and even to representatives of the banking commission. Disclosure is allowed only where a duty exists to testify or a duty to present information to a government official.85/

The identical provisions have been enacted in both the Bahamas and the Cayman Islands. It prohibits unauthorized disclosure of the affairs of any customer of a licensed bank or trust company which anyone obtains in the performance of his duties or the exercise of his functions under the law. The penalty is a fine of up to US$2,400 or 1 year in prison or both.86/

83/ R. Schlesinger, Comparative Law 570-79 (1970); see also Langer, supra note 82, at 101.

84/ Langer, supra note 82, at 100; see also B. Spitz, International Tax Planning 94-95 (1972).

85/ See, e.g., B. Kostelanetz et al., Secret Foreign Bank Accounts (Practicing Law Institute, 1973), especially J. Muller, Banking and Economic Confidentiality under Swiss Law, at 9-53; see also Meier, supra note 24, passim; and Kronauer, supra note 24, passim.

86/ Banks and Trust Companies Regulatory Act of 1965 of the Bahamas Islands sec. 10 (Law 64 of 1965); and Banks and Trust Companies Regulatory Law 1966 of the Cayman Islands sec. 10 (Law 8 of 1966); see Langer, supra note 82, at 99; see also S. Pine, Tax and Business Benefits of the Bahamas, 2 Tax Ideas (Prentice-Hall, Inc.) para. 24,033.

In several cases, U.S. and foreign persons, after being compelled to testify in the United States, have claimed that they were under a duty to remain silent under their own law. When these claims have been litigated, U.S. courts have balanced the need for disclosure against the severity and likelihood of foreign sanctions. Most of the decisions have been in favor of disclosure.87/ Even if a person is a citizen of a jurisdiction with criminal penalties against disclosure, the U.S. court will employ the same balancing technique.88/

In practice, compelling foreign bankers or government officials to testify is counterproductive. Recently, a foreign banker was subpoenaed and compelled to give testimony to a U.S. grand jury. The subpoena was upheld and the compulsion of his testimony was sustained, but he never gave testimony. As a result of the incident, his government enacted new and more stringent secrecy legislation, apparently in direct response to U.S. efforts to obtain disclosure.89/ Since many experts recommend that the United States should consider making international conventions providing for the exchange of information to solve the layering problem, and since many developing countries (and tax-haven jurisdictions) already feel that the United States is not willing to offer enough in exchange for such conventions, the United States may gain more in the long term by not compelling such testimony where it violates secrecy laws of another sovereign country.90/

Solving the Layering Problem Through Exchange of Information

By exchanging information with other countries, the United States can make substantial progress towards solving the layering problem. Although information can be exchanged most effectively under international conventions, it also is possible for the United States to exchange information in the absence of conventions.

Under existing U.S. law, any attempt by the Internal Revenue Service to give information to a foreign government in the absence of a convention would violate the Internal Revenue Code and subject officials to severe criminal and civil liabilities. Hence, Robert T. Cole, a tax practitioner in Washington, D.C., and former international tax counsel, has suggested that consideration might be given to amending the Code to allow the Internal Revenue Service to exchange information on a reciprocal basis in the absence of a convention. In this way, the United

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87/ United States v. First National City Bank, 366 F.2d 897, 901 (2d Cir. 1968); see also Note, Foreign Nondisclosure Laws and Domestic Discovery Orders in Antitrust Litigation, 88 Yale L.J. 612 (1979).

88/ United States v. Field, 532 F.2d 404, 407, rehearing denied, 535 F.2d 660 (5th Cir. 1976), cert. denied, 45 U.S.L.W. 3341 (Nov. 9, 1976).

89/ The Confidential Relationships (Preservation) Law of the Cayman Islands (Law 16 of 1976).

90/ Hearings on Offshore Tax Havens, supra note 1 (statement of H. Dale, at 18).

States could request information from countries with which it does not have a treaty with the ability to offer reciprocity. Cole believes that such legislation could be enacted if safeguards were inserted to ensure fairness with respect to the means of implementing the provisions and handling specific requests (see the discussions on procedural safeguards for supplying information under bilateral tax treaties and the U.S. conventions on mutual assistance in criminal matters in this chapter).[91/]

The most effective means to exchange information is through entering into conventions. Although exchange of information provisions can be incorporated into normal U.S. bilateral tax conventions, this approach is not feasible since the United States is experiencing difficulty in negotiating and ratifying tax conventions, particularly with developing countries, and it is the developing countries where many of the layers used to invest in the United States are located.

Another approach, which at least four foreign tax experts recommended at the hearings on offshore tax havens by the Subcommittee on Oversight of the House Ways and Means Committee,[92/] is for the United States to conclude "minitreaties" or treaties which are limited to providing for the exchange of information.

Before considering the potential contents of such treaties, another suggested reform, which addresses the political problem precluding the United States from successfully negotiating and ratifying treaties, should be considered. The lack of coordination between the U.S. executive and legislative branches in tax treaty policy has already been noted. To solve this problem, Robert T. Cole has recommended that a joint select committee of Congress, with members from the Senate Foreign Relations Committee, the Senate Finance Committee, and the House Ways and Means Committee, be formed to review treaty negotiations, and, thereafter, to work as a liaison group which would work with the Department of the Treasury in negotiating treaties and assisting in their ratification.

Marshall Langer, a tax practitioner in Miami, has proposed a plan under which the United States would invite every country with which it does not already have a bilateral income tax treaty to sign an information exchange agreement.[93/] Although Langer has not detailed what the contents of such treaties should be, Harvey Dale, a tax practitioner in New York City, has suggested that they may deal with exchange of information, the creation of competent authority procedures, and perhaps transfer-pricing issues.[94/] Dale has noted that minitreaties might be effective in exchanging information even under U.S. domestic law since the courts have held that Section 7602 of the Internal Revenue Code is

91/ Id. (statement of R. Cole, at 8).

92/ Id. (statement of H. Dale, at 17-19, statement of M. Langer, at 8-14, and oral remarks by D. Rosenbloom).

93/ Id. (statement by M. Langer, at 8).

94/ Id. (statement by H. Dale, at 17).

available to tax treaty partners,[95] and because the Code already allows an exception to antidisclosure provisions for giving tax return information to treaty partners of the United States.[96]

Langer's plan is that after the United States invites countries to sign the exchange of information agreement, it should categorize every country in the world as follows:

-- Type A: Those with which the United States already has an income tax treaty;

-- Type B: Those which sign an information agreement; and

-- Type X: Those with which the United States cannot obtain either an income tax treaty or an information exchange agreement.

Under the Langer proposal, the United States would amend the Internal Revenue Code to end benefits given to foreign persons resident in X countries: such persons would be subject to withholding tax on all income and gains from U.S. sources without exception; U.S. shareholders of controlled foreign corporations that are incorporated in or managed in Type X countries would no longer benefit from tax deferral. The objective of the plan would be to isolate offshore financial centers encouraing illegitimate tax evasion business. To provide incentives to governments to conclude these agreements, the United States would give other tax benefits where appropriate to compensate for revenue losses to the offshore financial centers. The Langer proposal, by carefully limiting such agreements to cover only alleged criminal activities, such as tax crimes amounting to a felony, would make such an agreement palatable to foreign governments. If enacted, this proposal would diminish substantially the number of tax havens, and make it more difficult and costly for the tax evader. Most professionals probably would refuse to assist persons using entities in X countries and the IRS could more easily monitor tax evasion if it were restricted to a limited number of X countries. Much more risk and uncertainty would confront the prospective tax evader.[97]

Joe Guttentag, a tax practitioner in Washington, D.C., also has suggested that the United States use a type of carrot and stick approach to motivate countries to conclude exchange-of-information agreements. For instance, the United States could consider concluding agreements with other major countries, perhaps through international organizations such as the International Monetary Fund, to restrict banking operations, transportation, communication, and immigration, or impose other sanctions with respect to countries to exchange information.[98]

95/ U.S. v. Burbank & Co., Ltd., 525 F. 2d 9, 16 (2d Cir. 1975), cert. denied, 426 U.S. 934 (1976).

96/ I.R.C. sec. 6103(k)(4).

97/ Hearings of Offshore Tax Havens, supra note 1 (statement by M. Langer, at 8-10).

98/ Id. (statement by J. Guttentag, at 30).

Harvy Dale and Marshall Langer have suggested that the U.S. Congress consider legislation to authorize the concluding and putting into force exchange-of-information agreements without awaiting ratification from the U.S. Senate. In particular, Dale suggested consideration of the following:

1. The adoption of a new Code provision authorizing the President or the Secretary of the Treasury to enter into bilateral agreements for the exchange of information;

2. Such agreements would have to be submitted to Congress and would not become effective for a period of 90 days after such submission (following the procedure applicable to the "totalization" agreements in social security matters discussed in an earlier section of this chapter);

3. An amendment to Section 6103(k)(4) of the Internal Revenue Code to make available tax return information to contracting states concluding such executive agreements; and

4. An amendment to Section 7602 of the Code to authorize the issuance of subpoenas to aid the contracting states.[99]

Other methods of exchanging information to solve the offshore tax-haven problem have been suggested. Joe Guttentag has suggested that the United States consider making increased use of the simultaneous audit procedures (see the earlier section on working arrangements).[100] Guttentag, while suggesting that the United States should consider making increased use of exchange-of-information conventions, also has emphasized the importance of using the information only for the purposes specifically set forth in a treaty and safeguarding the confidentiality of such information. In addition, Guttentag has suggested that if a foreign government requests information concerning the foreign tax liability of a U.S. citizen or resident, it would be appropriate to notify the taxpayer involved and allow him the opportunity to challenge the right or appropriateness of the United States in providing the information. In this manner, a U.S. taxpayer may prevent the United States from improperly furnishing information.[101]

Many recommendations have been provided to the U.S. Congress, particularly in hearings of the House Subcommittee on Oversight of the Ways and Means Committee, on the possibility of using exchanges of information to solve the layering problem. Ultimately, the mechanisms must be tailored to the problems and the objectives. Both of the latter await more definition.

99/ *Id.* (statement by H. Dale, at 17-18, and statement by M. Langer, at 11).
100/ *Id.* (statement by J. Guttentag, at 29).
101/ *Id.* (statement by J. Guttentag, at 32).

Other Mechanisms to Supplement Exchange of Information

To accomplish the goal of obtaining statistical information, the United States could consider merely exchanging information on aggregate data which do not identify individual foreign investors. The United States could consider working through the Organization for Economic Cooperation and Development (OECD) Declaration of International Investment and Multinational Enterprises as well as through the U.N. Commission on Transnational Corporations for possible consideration of uniform regulations on disclosure by multinational enterprises and to provide for exchange of statistics on foreign direct investments.

The United States could work in a multilateral context to improve and supplement exchanges of information on specific transactions and participants therein. It could work through the Fiscal Committee of the OECD. It could work through United Nations organizations, such as the U.N. Group of Experts on Tax Treaties Between Developed and Developing Countries. It also could work through regional organizations such as the Inter-American Center of Tax Administration.[102/]

The subject-matter areas which the United States could discuss in the organizations set forth in the preceeding paragraph are increased use of joint tax audits, designing more uniform documents and taxpayer identification numbers, and other innovative ways to utilize information exchanged under tax treaties, such as magnetic tapes. It could discuss new mechanisms in the Directive of the European Economic Community for closer cooperation in exchanging information under tax treaties. This would include better routine exchanges, more possibilities for spontaneous exchanges, exchanges of information concerning taxpayers' activities in a third country, and closer and more regular consultation by tax authoriities.

The United States also could consider the establishment of a worldwide Intergovernmental Tax Cooperation Organization, which in one article has been referred to as Intertax. Such an organization would integrate several cooperative activities and programs. Although many cooperative international tax activities--such as exchanges of information, competent authority provisions, enforcement activities, agreements on allocation of jurisdiction, exercising jurisdiction, relief from double taxation, and furnishing technical assistance to national tax administrations--may not individually be considered worth the cost of undertaking them, when they are taken together, their benefits may make such activities worthwhile.[103/]

102/ *See*, *e.g.*, *The Exchange of Information under Tax Treaties*, Publications of the Int'l Bur. of Fiscal Documentation No. 25, Proceedings of the 19th Technical Confer. of the Inter-American Center of Tax Adminis., Aug. 28-Sept. 3, 1977 (International Bureau of Fiscal Documentation, Amsterdam, 1978).

103/ Surr, *Intertax: Intergovernmental Cooperation in Taxation*, 7 Harv. Int'l Law Club J. 179 (1966).

The United States also could consider the conclusion of treaties of mutual assistance in criminal matters and amending existing Federal laws to facilitate furnishing assistance in criminal matters.

Most importantly, before the U.S. Government decides to take an approach which will have international impacts, it should have a uniform, consistent internal approach. In devising tax treaties, in cooperating in law enforcement activities concerning crimes with international elements, and in collecting and analyzing statistics on foreign investment, U.S. agencies and the executive and legislative branches of government will be required to coordinate their efforts.

Chapter 19

AVAILABLE DATA: A CRITICAL REVIEW

Kenneth P. Burke*

INTRODUCTION

The report of the President's Commission on Federal Statistics states that "public confidence in data gathering should be increased...mostly in handling of program and regulatory data."1/ As a measure of concern for the handling of data, the following statistical information on foreign investment in real estate has been evaluated in respect to their accuracy, and then assessed in terms of what the data seem to indicate.

No matter how clearly presented and carefully worded, the data are open to misinterpretation, misquotation, and manipulation. Therefore, the issue of misuse of data in general and the data herein presented in particular are addressed as a problem of statistical information in a political milieu. Misstated data have the potential, in the case of foreign investment in the United States, of producing considerable unwarranted national anxiety and adverse international response.

THE DATA

The data in this report pertain to completed transactions. Not until a transaction has passed from the realm of "under negotiation" or "pending" or "speculation" into "finalized" or "signed" or "completed" has it been included.

Data Sources

The data were received from numerous sources. Approximately half of the reported transactions were culled from newspapers, magazines, and professional journal clippings. Initially, the clippings were collected by individuals in the Economics, Statistics, and Cooperatives Service of

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1/ President's Commission on Federal Statistics, Federal Statistics Report, U.S. Government Printing Office, Washington, D.C. 1971, pp. 2, 3.

the U.S. Department of Agriculture. Since May 1978, items have been supplied by Burelle's commercial clipping service of Livingston, N.J.

Another prominent source of reported transactions was the U.S. Department of Commerce, Industry and Trade Administration, Office of Foreign Investment in the United States, Investment Analysis Division, Foreign Direct Investment Activity reports. These "ITA" reports, which are published monthly, consist of information collected entirely from documents and reports that are publicly available, not from surveys or questionnaires which contain "business confidential" data. Three general types of sources are used to prepare the ITA reports: (1) Federal and State agencies, such as the Securities Exchange Commission and the Federal Reserve Board; (2) the mass and business media; and (3) research or reference material, such as that published by the major financial reporters--Moody's, Dun and Bradstreet, Standard and Poors, etc.

Other sources of data which were reviewed and used to evaluate the aggregate transactions listed in the tables were: (1) the January 1979 report on Foreign Investment in United States Agricultural Land, Senate Committee on Agriculture, Nutrition, and Forestry; (2) U.S. Department of Agriculture, Resource Economics Survey and Farm Real Estate Market Developments; (3) U.S. Department of Commerce, Bureau of Economic Analysis; (4) U.S. General Accounting Office farmland study; (5) Bureau of the Census, economic and agricultural statistics; (6) National Association of Realtors; (7) International Association of Assessing Officers; (8) Direct Investment/USA, a biweekly publication of the Alexander Hamilton Institute, New York City; (9) Price Waterhouse, Inc.; (10) Probe, Inc.; (11) The Conference Board; and (12) miscellaneous other sources as available.

The compilations in this report were compared with a survey computer analysis done by Larry Walker[2/] and the recent Harris foreign investment survey[3/] which is discussed in this chapter. A semiannual review of the farm-rural real estate situation also has been done by the Economics, Statistics, and Cooperatives Service. Although focusing on the market values of rural real estate, several questions in the survey do broach the issue of foreign investment. Participating in the survey was a sample of approximately 4,040 "real estate observers"--brokers, lenders, some tax assessors, and a few farmers. The small size of the sample may contribute to inaccuracy in the survey, but added to this is a tendency toward ambiguity in many of the questions, such as: "Is foreign purchase of farm real estate having any significant impact on the land market in your local area?" Such a question can only be answered subjectively. Nevertheless, little else is available to trace trends and/or the impressions of real estate professionals.

2/ Special tabulation by Larry Walker, National Economic Analysis Division, Economics, Statistics, and Cooperatives Service, U.S. Department of Agriculture, in Farm Real Estate Market Developments, August 1979.

3/ Harris, Louis, "Foreign Investment," The Chicago Tribune-New York News Syndicate, March 1979.

The Data Tables

In table 1, the data have been accumulated in the following manner: number of cases reported completed since January 1, 1977, number of those cases in which a value (purchase price) was reported, the value of those purchase payments, the number of cases in which the acreage was reported, and the total acreage changing hands.4/ These data have been categorized by the country in which the foreign purchaser is domiciled, claims citizenship, or is incorporated.

In table 2, the data have been accumulated as in table 1 but have been categorized by the State in which the purchased real estate is located. For purposes of further comparison, the States have been grouped into geographical regions and subtotaled. An additional breakdown is made in these State summaries beyond the country summaries--completed case quantitites are expressed as either "urban" or "rural."

DATA EVALUATION

Because the majority of the transactions reported in summary tables 1 and 2 were gathered from the mass and business media, the figures represent only an approximation of foreign direct investment in U.S. real estate. Throughout 25 of the 30 months during which data were accumulated, there were no resources available to verify the reports received or to accurately supplement the data. Since February 2, 1979, the requirements of the Agricultural Foreign Investment Disclosure Act have produced data of verification or supplementation value, but only for agricultural lands and not in time to be useful in this report.

As much as possible, an attempt was made to eliminate the duplication of reported transactions. Often, though, it was virtually impossible to determine if a reported transaction was a duplicate because sources did not include the same pertinent identifying information, such as the name of the purchasing foreign individual or corporation, the name of the domestic seller, or the location and type of property acquired.

4/ Plot sizes reported in square feet, square meters, and square miles were converted into acres.

Table 1--Completed real estate transactions, by country, January 1, 1977, through June 30, 1979

Country (region)	No. of completed cases	Dollars invested		Acreage purchased	
		No. cases known	Million	No. cases known	Acres
Canada	194	122	3,308.50	80	64,589
Latin America (excluding Cuba)					
Argentina	2	1	1.00	1	15,000
Brazil	1	1	1.95	1	850
Bolivia	-	-	-	-	-
Belize	-	-	-	-	-
Chile	-	-	-	-	-
Colombia	4	3	13.66	0	-
Costa Rica	-	-	-	-	-
Dominican Republic	-	-	-	-	-
Ecuador	-	-	-	-	-
El Salvador	-	-	-	-	-
Guatemala	2	0	-	2	493
Guyana	-	-	-	-	-
Haiti	-	-	-	-	-
Honduras	1	0	-	1	40
Jamaica	-	-	-	-	-
Mexico	8	7	22.31	3	652
Nicaragua	-	-	-	-	-
Panama	8	6	16.43	6	4,880
Paraguay	-	-	-	-	-
Peru	-	-	-	-	-
Surinam	-	-	-	-	-
Uruguay	1	0	-	0	-
Venezuela	4	3	22.60	2	23,030
Subtotal	31	21	77.95	16	44,945

(Continued)

Table 1--Completed real estate transactions, by country, January 1, 1977, through June 30, 1979

Country (region)	No. of completed cases	Dollars invested		Acreage purchased	
		No. cases known	Million	No. cases known	Acres
Western Europe					
Austria	8	5	8.08	7	12,152
Belgium	12	5	7.73	5	1,539
Denmark	4	3	5.25	1	160
Finland	1	1	.14	1	147
France	20	13	258.52	11	171,103
Germany, Federal Republic of	110	55	650.93	82	117,125
Great Britain	45	28	548.35	13	3,282
Greece	1	1	.18	0	-
Ireland	1	0	-	1	310
Italy	19	12	79.00	16	238,633
Liechtenstein	10	3	4.97	8	80,060
Luxembourg	-	-	-	-	-
Multinational	25	15	124.25	11	37,615
Netherlands	53	29	246.91	28	116,647
Norway	3	0	-	2	163
Portugal	-	-	-	-	-
Spain	2	2	17.20	1	18
Sweden	4	2	35.35	3	61
Switzerland	22	10	52.75	11	7,577
Turkey	-	-	-	-	-
Undetermined	7	5	18.87	4	1,244
Subtotal	347	189	2,058.48	205	787,836
Eastern Europe					
Bulgaria	-	-	-	-	-
Czechoslovakia	1	0	-	1	320
Germany, Democratic Republic of	-	-	-	-	-
Hungary	1	1	2.50	0	-
Poland	-	-	-	-	-

(Continued)

Table 1--Completed real estate transactions, by country, January 1, 1977, through June 30, 1979

Country (region)	No. of completed cases	Dollars invested: No. cases known	Dollars invested: Million	Acreage purchased: No. cases known	Acreage purchased: Acres
Romania	-	-	-	-	-
Union of Soviet Socialist Republics	2	0	-	1	12
Yugoslavia	-	-	-	-	-
Subtotal	4	1	2.50	2	332
Middle East/North Africa					
Algeria	-	-	-	-	-
Egypt	-	-	-	-	-
Iran	22	14	308.17	10	4,028
Iraq	2	-	-	-	-
Israel	-	-	-	-	-
Jordan	-	-	-	-	-
Kuwait	7	5	150.80	1	46
Lebanon	2	1	.80	2	3,080
Libya	-	-	-	-	-
Morocco	-	-	-	-	-
Saudi Arabia	22	15	143.75	15	55,906
Syria	-	-	-	-	-
Tunisia	-	-	-	-	-
Undetermined	2	2	6.20	0	-
Subtotal	57	37	609.72	28	63,060
Lower Africa					
Ethiopia	-	-	-	-	-
Kenya	-	-	-	-	-
Liberia	-	-	-	-	-
Niger, Republic of	1	1	.80	0	-
Nigeria	-	-	-	-	-

(Continued)

Table 1--Completed real estate transactions, by country, January 1, 1977, through June 30, 1979

Country (region)	No. of completed cases	Dollars invested		Acreage purchased	
		No. cases known	Million	No. cases known	Acres
South Africa	2	2	4.40	0	-
Sudan	-	-	-	-	-
Tanzania	-	-	-	-	-
Zaire	-	-	-	-	-
Subtotal	3	3	5.20	0	-
Asia/Oceana					
Afghanistan	-	-	-	-	-
Australia	3	2	7.80	1	300
Burma	-	-	-	-	-
China, Peoples Republic of	-	-	-	-	-
Hong Kong	8	3	11.00	0	-
India	12	1	1.50	0	-
Indonesia	-	-	-	-	-
Japan	35	9	66.63	21	2,182
Malaysia	1	1	2.25	0	-
New Zealand	-	-	-	-	-
Pakistan	-	-	-	-	-
Philippines	-	-	-	-	-
Singapore	-	-	-	-	-
South Korea	4	2	5.13	1	20,000
Taiwan (China, Republic of)	4	2	14.05	1	46
Thailand	1	1	1.00	0	-
Subtotal	68	21	104.71	24	22,528

(Continued)

Table 1--Completed real estate transactions, by country, January 1, 1977, through June 30, 1979

Country (region)	No. of completed cases	Dollars invested: No. cases known	Dollars invested: Million	Acreage purchased: No. cases known	Acreage purchased: Acres
Miscellaneous					
Bermuda	1	1	3.30	0	-
Cayman Islands	1	1	.75	0	-
Netherlands Antilles	44	31	172.59	30	51,419
Iceland	-	-	-	-	-
Undetermined	26	19	72.89	18	64,036
Subtotal	72	52	249.53	48	115,455
Total	776	446	6,416.59	403	1,098,745

Table 2--Completed real estate transactions, by State, January 1, 1977, through June 30, 1979

State (region)	No. of completed urban cases	No. of completed rural cases	Dollars invested: No. cases known	Dollars invested: Million	Acreage purchased: No. cases known	Acreage purchased: Acres
Northeast						
Maine	3	0	3	12.50	0	-
New Hampshire	3	0	1	2.00	0	-
Vermont	1	1	1	25.00	0	-
Massachusetts	15	1	12	359.81	4	489
Rhode Island	3	0	2	1.71	2	3

(Continued)

Table 2--Completed real estate transactions, by State, January 1, 1977, through June 30, 1979

State (region)	No. of completed urban cases	No. of completed rural cases	Dollars invested: No. cases known	Dollars invested: Million	Acreage purchased: No. cases known	Acreage purchased: Acres
Connecticut	6	0	3	15.85	3	212
New Jersey	5	1	5	42.30	2	2,070
New York	31	14	19	582.36	8	4,046
Pennsylvania	8	2	7	67.40	2	1,702
Delaware	1	0	0	-	0	-
Maryland	10	7	13	73.49	10	6,446
District of Columbia	17	0	13	145.70	1	12
Subtotal	103	26	79	1,328.12	32	14,980
South						
Virginia	19	14	17	164.83	23	10,113
West Virginia	1	1	0	-	1	10,000
Kentucky	3	2	2	57.00	1	10,000
Tennessee	18	2	13	56.38	9	10,354
North Carolina	5	1	3	18.17	2	33
South Carolina	6	3	5	83.01	4	3,030
Georgia	19	14	19	81.60	23	78,224
Florida	110	17	86	1,159.72	45	47,755
Arkansas	1	6	1	1.40	6	33,927
Louisiana	4	9	4	272.80	10	67,674
Mississippi	-	-	-	-	-	-
Alabama	2	0	0	-	0	-
Subtotal	188	69	150	1,894.91	124	271,110
Midwest						
Ohio	7	0	3	22.65	2	4
Michigan	7	8	9	107.71	9	1,172
Indiana	3	3	3	8.40	2	4,500
Illinois	24	8	16	264.10	11	31,470
Wisconsin	2	2	2	19.00	2	212

(Continued)

Table 2--Completed real estate transactions, by State, January 1, 1977, through June 30, 1979

State (region)	No. of completed urban cases	No. of completed rural cases	Dollars invested: No. cases known	Dollars invested: Million	Acreage purchased: No. cases known	Acreage purchased: Acres
Missouri	2	7	2	27.61	6	34,713
Iowa	0	25	6	29.29	23	12,503
Minnesota	7	15	20	229.34	15	25,697
Kansas	1	3	1	8.00	1	2,500
Nebraska	1	0	0	-	0	-
North Dakota	-	-	-	-	-	-
South Dakota	0	12	5	2.62	12	9,681
Subtotal	54	83	67	718.72	83	122,452
West/Mountain						
Montana	0	2	1	.55	2	6,100
Wyoming	0	3	3	20.80	3	202,823
Colorado	28	8	25	462.45	29	76,628
Utah	0	3	0	-	3	20,900
Nevada	1	1	1	46.40	0	-
Idaho	-	-	-	-	-	-
Subtotal	29	17	30	530.20	37	306,451
Southwest						
Oklahoma	4	0	2	19.00	3	100
Texas	67	14	46	718.71	41	82,859
New Mexico	0	2	0	-	1	3,400
Arizona	2	2	2	8.10	2	70
Subtotal	73	18	50	745.81	47	86,429
Pacific Coast						
California	75	21	60	1,073.71	63	54,468
Oregon	1	7	2	75.70	10	213,747
Washington	6	3	6	37.22	6	29,096
Subtotal	82	31	68	1,186.63	79	297,311

(Continued)

Table 2--Completed real estate transactions, by State, January 1, 1977, through June 30, 1979

State (region)	No. of completed urban cases	No. of completed rural cases	Dollars invested: No. cases known	Dollars invested: Million	Acreage purchased: No. cases known	Acreage purchased: Acres
Outer Extremes						
Alaska	-	-	-	-	-	-
Hawaii	3	0	2	12.20	1	12
Puerto Rico	-	-	-	-	-	-
Virgin Islands	-	-	-	-	-	-
Guam	-	-	-	-	-	-
Northern Marianas	-	-	-	-	-	-
American Samoa	-	-	-	-	-	-
Trust Territories	-	-	-	-	-	-
Subtotal	3	0	2	12.20	1	12
Total	532	244	446	6,416.59	403	1,098,745

Table 3--Summary projections based on known transactions from Tables 1 and 2

Tract type	No. of completed cases	Cases with value known: Number	Cases with value known: %	Value (millions of dollars): Observed	Value (millions of dollars): Projected
Urban	532	350	66	5,919.3	8,962.0
		Cases with acres known		Acreage	
		215	40	56,366	140,915

(Continued)

Table 3--Summary projections based on known transactions from Tables 1 and 2

Tract type	No. of completed cases	Cases with value known		Value (millions of dollars)	
		Number	%	Observed	Projected
Rural	244	96	39	497.3	1,275.0
		Cases with acres known		Acreage	
		188	77	1,042,379	1,354,051

Table 4--Urban-Rural Comparison

Gauge of Measure	Urban Cases		Rural Cases	
	Quantity	%	Quantity	%
Number of cases	532	68	244	32
Projected value (millions of dollars)	8,962	88	1,275	12
Projected area (acres)	140,915	9	1,354,051	91

Table 5--Total transfers of U.S. private land[5/] to foreign ownership

Period	Landownership transfer to foreigners	
	Area (millions acres)	Value ($ millions)
To 1974[6/]	4.9	6,184[7/]
1975	N/A	505[8/]
1976	N/A	560[8/]
1977 through June 30, 1979[9/]	1.5	10,237
Total	6.5+	17,486

The above totals indicate that approximately 1 percent of U.S. private land is in foreign hands.

5/ Privately owned land in the United States totals 1.3 billion acres (58% of all U.S. land); from, Boxley, Robert F. Landownership Issues in Rural America. U.S. Dept. of Agriculture. This privately owned land is valued at about $1,640 billion (this is 81% of the value of all U.S. land); from Statistical Abstract, 1975, projected to 1979.

6/ Estimate from U.S. Senate Committee on Agriculture, Nutrition, and Forestry. Foreign Investment in United States Agricultural Land. U.S. Government Printing Office, Washington, D.C., 1979.

7/ Estimate based upon acres transferred (see footnote 6) and mean average value per acre of all U.S. privately owned land.

8/ U.S. Dept. of Commerce. Foreign Direct Investment in the U.S. December 1977.

9/ Projected estimates from table 4.

Difficulty in maintaining accuracy also was increased by a large portion of transaction reports having been incomplete in basic statistical information; i.e., the purchase price was undisclosed, and acreage was considered irrelevant and thus went unreported,[10] etc.

Data from the media often do not specify the purchaser's equity in the real estate and changes in that equity since the initial purchase; the nationality of the seller (did the real estate merely go from one foreign owner to another?); and, layered corporation's subsidiaries and multiple nationality partnerships (often of unspecified numbers and nationalities). Despite their shortcomings, however, the data that have been collected are the best available without special surveys which were neither authorized nor possible in the time alloted for the study. They do provide a helpful indicator of the general trends of foreign direct investment in U.S. real estate.

Most of the reports received cited the equity of the investor in the purchased real estate as 100 percent. In the cases in which the foreign investor's equity was less than 100 percent, we included the purchase price that he or she paid in the value known column. Out of the 446 transactions in which the value or purchase price was known (as of June 30, 1979) only 49 transactions represent an equity investment by the foreign purchaser of less than 100 percent. Finally, there was no means by which this data collection program could economically assemble information on the transfer of real property in the United States out of foreign hands and back into American hands.

The Rate of Investment

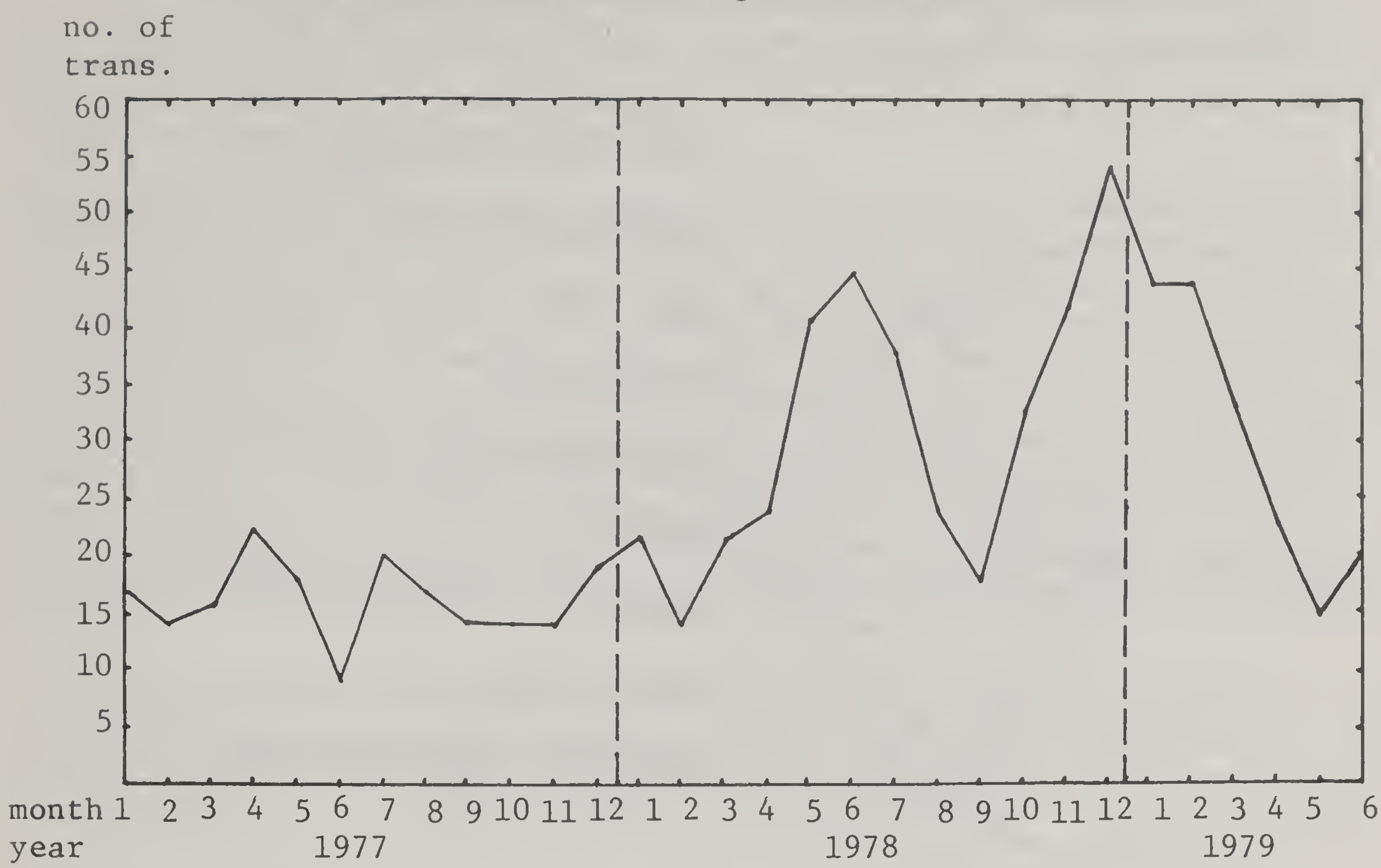
The following graph (figure 1) is a display of the month-by-month quantity of completed transactions in which a real estate purchase was made by a non-American or foreign corporation during our data collection period (January 1, 1977, through June 30, 1979).

While not all transactions were reported and have not been included in these monthly transaction totals, we can assume that a proportionate quantity is missing from each monthly total. The graph shows peaks at June 1978 and December 1978. These rises and declines may result from numerous factors, including international economic conditions. The December peak, for example, might include an anticipation of Agricultural Foreign Investment Disclosure Act regulations,[11] and many new State prohibitions, restrictions, and registration requirements.

10/ Acreage in urban transactions often is not reported because the magnitude of an urban purchase, particularly in the "downtown" district, is more meaningfully reported in monetary terms.

11/ Foreign investors making purchases under-the-wire to avoid potential penalties which would be imposed with the revelation, in the country of their citizenship or incorporation, of the purchase while being unaware of the details of registering transactions retroactively, etc. See chapter 6 for a review of the penalty issue.

Figure 1--Monthly totals of foreign investment transactions

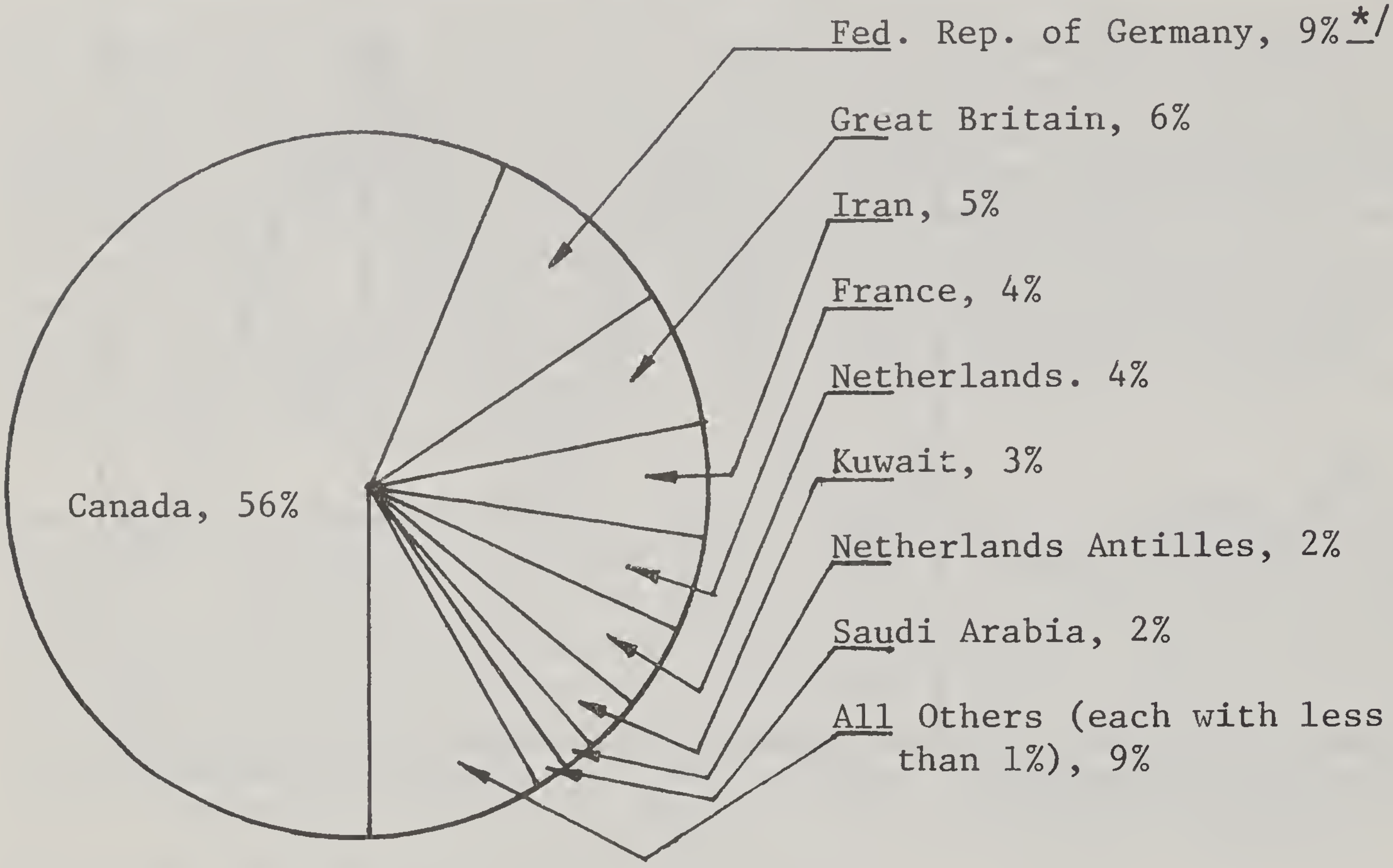


Country-by-Country Investment Levels

The data in table 1 are displayed in the pie graphs in figures 2 and 3. The upper graph displays the proportions of investment in terms of monies exchanged in the purchase transaction, while the lower graph displays the proportions of acreage that those monies bought.

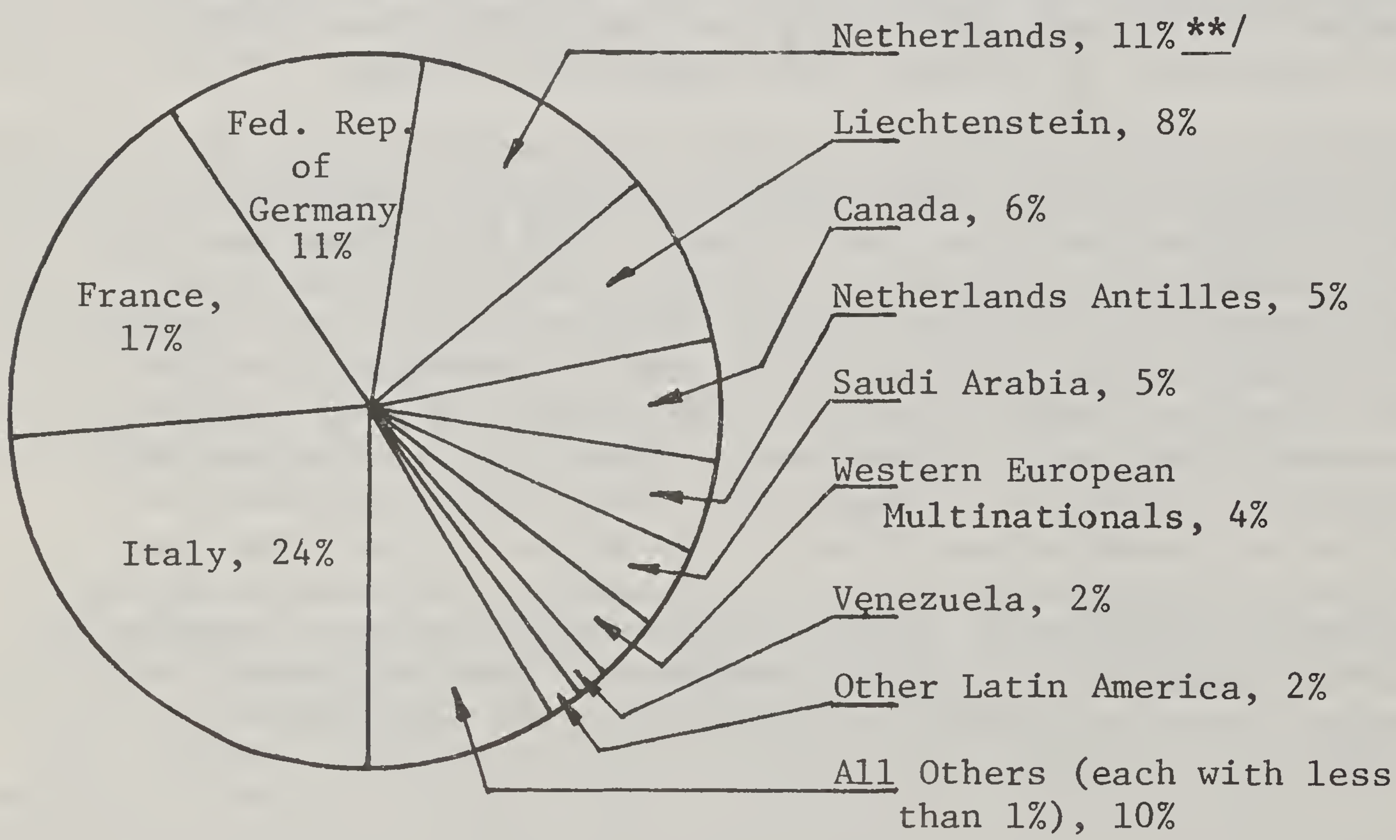
These graphs show that the majority of recent capital investment in American real estate has come from Canada. In making a comparison between the two graphs, one finds that Canadian investors have made a high monetary investment (56 percent of total) with a relatively low acreage accumulation (6 percent of total). This more than 9 to 1 ratio would seem to indicate that purchases have been concentrated in high-priced urban or suburban real estate; in fact, when reviewing the transactions one-by-one, we found a predominant proportion in urban shopping centers, factories, residential communities, urban office centers, or sites prime for the construction of any of these facilities. The capital/acreage ratio for Great Britain is very similar. An example of the opposite extreme is the case of Italy--a large accumulation of acreage and a relatively low level of capital investment. Italians appear to place an emphasis upon purchasing large, inexpensive, agricultural tracts of land.

Figure 2--Value of real estate transactions by country of purchaser for the period January 1, 1977 to June 30, 1979



*/ Percentages based on reports in which a value was reported. Generally values are total value of property and not equity.
Source: Unpublished data, Economics, Statistics, and Cooperatives Service, U.S. Department of Agriculture.

Figure 3--Acreage of real estate transactions by country for the period January 1, 1977 to June 30, 1979



**/ Acreage based on reports in which an acreage of area was reported.

Source: Unpublished data, Economics, Statistics, and Cooperatives Service, U.S. Department of Agriculture.

State-by-State Investment Levels

The data in table 2 are displayed in the pie graphs in figures 4 and 5. The upper graph, again, is concerned with monetary quantities and the lower one displays acreage quantities.

Reported favorite States for alien investors are the "sunniest"--Florida and California. New York is the third largest recipient of capital, but is at the low end of the scale in the quantity of acreage purchased (included in the 1 percent for "all of the Northeast") because of the great proportion of expensive urban real estate purchased. The mean price, per acre, of New York State purchases is approximately $60,000. In marked contrast, there are States in which purchases have been primarily rural. The Oregon investment level is very high on acreage but low on capital--only about $700 per acre. The sunbelt States (the South, Southwest, and California in the table 2 compilations) account for about half the capital invested by foreign investors in the United States.

A casual examination suggests some national (as in national home of investor) interest in particular States; i.e., Japan in California, Great Britain in Colorado, Luxembourg in Arkansas, the Netherlands in Florida.12/

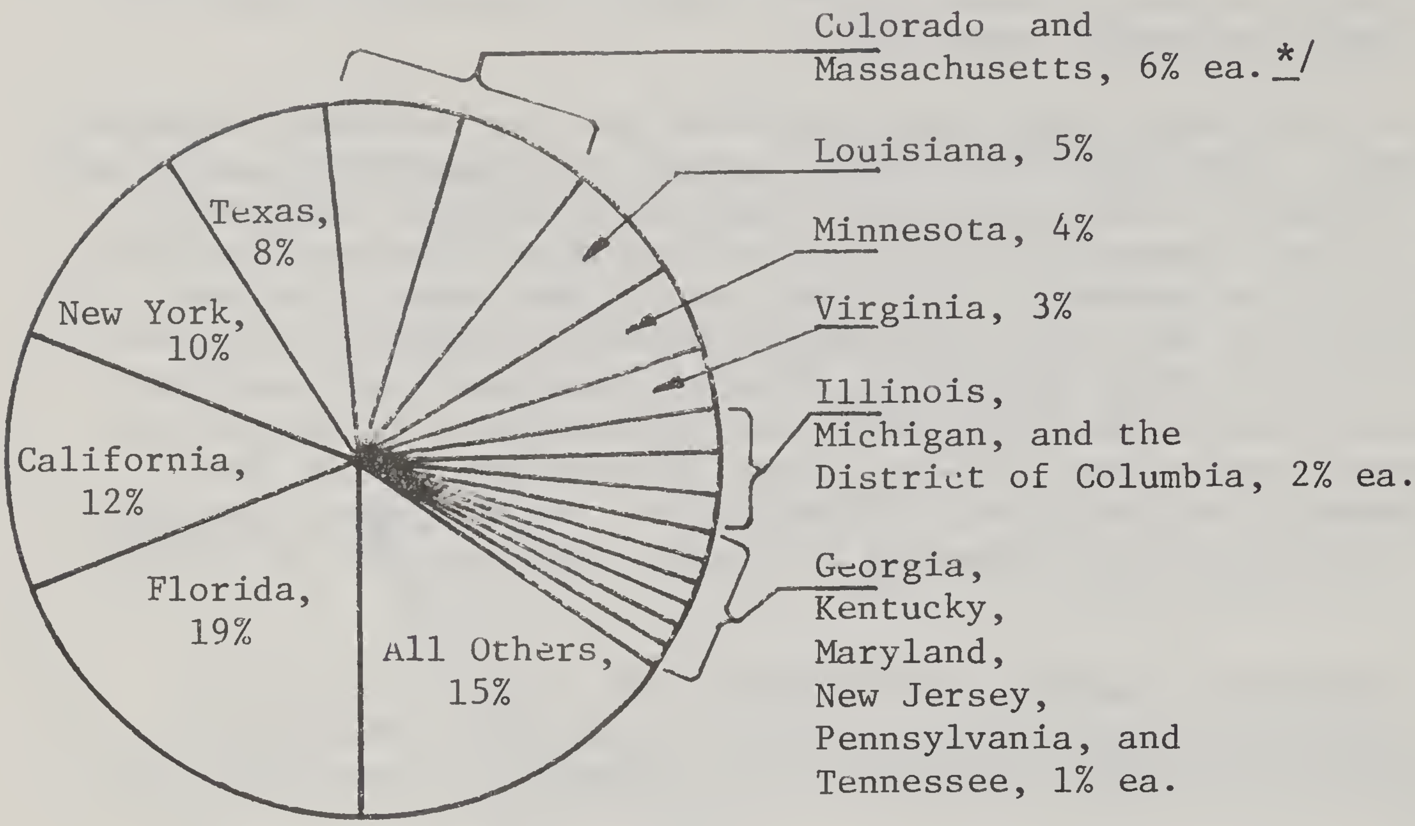
Urban-Rural Contrasts

Data collected on completed purchases of U.S. urban and rural real estate by foreigners/aliens also have been summarized in a subtabular form in table 2, as either rural or urban property. The acreage column in rural vs. urban real estate table represents mostly rural land, although other acreage is included. For example, roughly 20 percent of the total figure represents purchases of raw land parcels for development or resale. Also included is acreage on which shopping centers and residential estates or mansions are located.

Completed real estate transactions classified as "rural" include farmland (the great majority), residential estates or mansions, mining property, oil property, ranchland, orchards and citrus groves, timberland, vineyards, feedlots, desert land, and undeveloped sites, including beachfront lots on which there are no immediate plans for construction. "Urban" real estate transactions include commercial and industrial buildings (the majority in this classification), such as office buildings, specialty and department stores, shopping centers and malls, suburban strip-type development, industrial parks, warehouses, manufacturing plants, single- and multifamily homes on lots unsuited or undesigned for agrarian pursuits (the typical suburban residence), condominiums, apartment complexes, nursing homes, motels and hotels, other nonagrarian installations, and development sites on which is planned for construction manufacturing plants, residential developments, office buildings, or

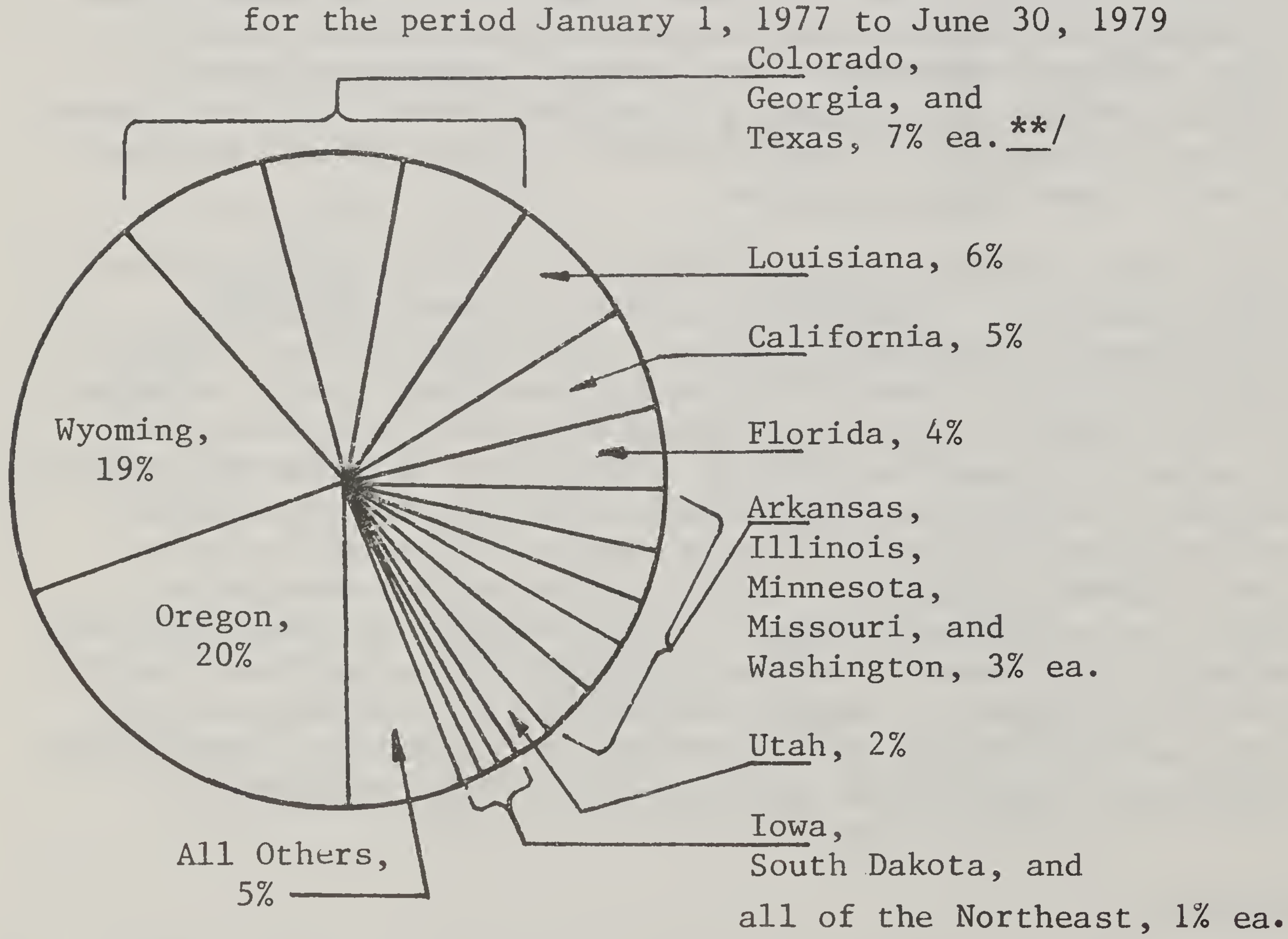
12/ See figure 4.

Figure 4--Value of real estate transactions by state for the period January 1, 1977 to June 30, 1979



*/ Total value of completed transactions.
Source: Unpublished data, Economics, Statistics, and Cooperatives Service, U.S. Department of Agriculture.

Figure 5--Acreage of real estate transactions by state for the period January 1, 1977 to June 30, 1979



**/ Total acreage acquired in completed transactions.
Source: Unpublished data, Economics, Statistics, and Cooperatives Service, U.S. Department of Agriculture.

other commercial facilities, etc. Grain terminals in urban locations are classified as "urban," but grain elevators used for storage in rural locations are classified as "rural."

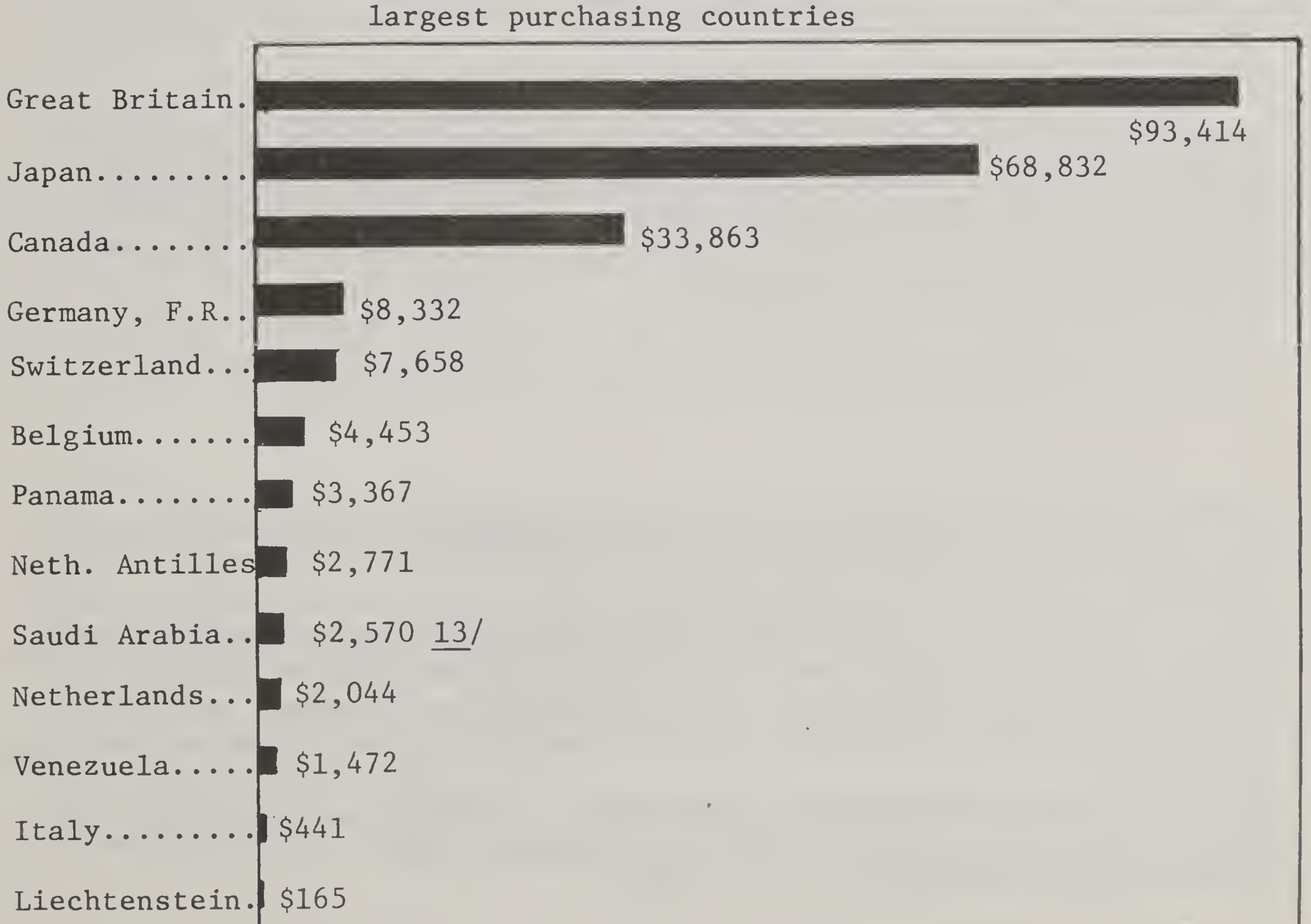
An effective method for determining the purchase preferences for different foreign investors is via determining the mean purchase price per acre in the total number of transactions for any one national classification. Figure 6 is a graphic representation of the mean purchase price per transaction acre of 13 of the larger foreign nationality investor groups.

The final price figure were arrived at by taking the total of capital investments from one national source and dividing by the total of acres accumulated by the same national source after adjusting those figures proportionally as necessary to equalize the number of cases where the value (purchase price) is known by the number of cases where the acreage is known. A good example to illustrate the method is the case of Canada:

122 cases with values known ($3,308.5 million)	vs.	80 cases with acreage known (64,589 acres)
80 adjusted cases (122 x .66) ($2,169.4 million)		

= mean price per acre ($33,863)

Figure 6--Price per acre paid by buyers from several of the largest purchasing countries



13/ See following page for footnote.

The graph illustrates the very great disparity in investment concentration. Although accuracy here is an open question,[13/] the wide range would leave most of these nations in the same relative position with as much as a 20-percent deviation in either direction.

In reviewing the two extremes in Figure 6 a finding is that almost all of the acreage purchased by Liechtenstein (lowest value per acre in figure 6)--99.8 percent of it--was bought in Texas and Arkansas, and no purchase price has, as yet, been reported. Thus, only two of six transactions have provided capital figures for a large national source of investment. Those two reported transaction purchase prices were for 5.5 acres and a case of unreported acreage, out of a total of 59,080.5 acres. The Liechtenstein price per acre must be much higher than we have been able to calculate. Highest prices are paid by the British. The 72 percent of individual or corporate urban cases, with prices reported, were purchases in the most urbanized areas; downtown Los Angeles, Greenwich Village in Manhattan, and prime chunks of downtown Chicago, Denver, and Houston stand out among these purchases.

THE IMPACTS OF FACTS

The reaction of the American press and public to the January 1979 report Foreign Investment in United States Agricultural Land by the Senate Committee on Agriculture, Nutrition and Forestry[14/] was at once rapid and significant. In view of the quantity of real estate that was reported to be in foreign hands (.4 percent), this reaction seems excessive.

The media, especially the newspapers, have contributed to the awareness of the foreign investment issue but little to the information about the issues.

In many of their reactions, newspapers are concentrating on local occurrences rather than reviewing the national picture. Some stories have appealed to readers' fear that the inception of a foreign investor into their domain heralds an "invasion of alien influence with the high potential to destroy their way of life."

13/ The prices per acre of transactions included in the Saudi Arabia classification are of the most dubious accuracy. Only two-thirds of the transaction reports revealed purchase prices and/or the quantity of real estate. Two cases of large urban transactions with significant data unrevealed are One Biscayne Tower (a 40-story office building in Miami, Florida) reporting a purchase of $49 million but no acreage, and the Plaza of the Americas in Dallas, Texas reporting 5.5 acres and no purchase price.

14/ U.S. Senate Committee on Agriculture, Nutrition, and Forestry. Foreign Investment in United States Agricultural Land. U.S. Government Printing Office, Washington, D.C., 1979.

Public Opinion Polls

Registering the fear and discontent of Americans in general and American farmers in particular are several recent opinion polls. In a Wallaces Farmer opinion poll, some 89 percent of the 430 farm men and women questioned in January 1979 disapproved of foreign investment in U.S. farmland.[15/] A similar opinion poll in Alabama, by the Progressive Farmer, also in January 1979, showed a 75-percent rate of opposition to foreign investment in U.S. farmland.[16/] The rates are extremely high due to large-tract sales in the locale of the poll, the high level of publicity given the issue in the media during the preceding 2 months, and the strong emotional ties of farmer respondents to the land and its association with their concept of America. Therefore, these figures are not reflective of the American citizenry in general. One poll that does do an effective job of polling the people of the United States in all geographic regions and in all professions is the Harris Poll on Foreign Investment of March 1979.[17/] Harris shows that 65 percent of the people believe there is more harm than good done to this country by foreign investors putting money into farmland in the United States. Opinions on other types of real estate are similar; 77 percent oppose the buying of shares of American companies, 56 percent oppose investment in office building and shopping malls, and a full 80 percent see harm in foreigners buying our natural resource real estate such as forests and coal mines. An even greater majority, about 15 percentage points higher in each case, wants restrictions on such investments and purchases. These figures, as stated by Louis Harris, express one fact more than any other, "Americans seem to feel that national pride is at stake, and many are genuinely worried that ultimate control of the economy might pass into foreign hands."[18/]

A curious difference in respondents' opinions occurs when a subset of specialists is polled. The survey taken by Larry Walker[19/] of 4,040 real estate professionals showed that only 25 percent of these people who deal in and with real estate thought that foreign ownership of American real estate is undesirable. Walker's survey revealed that, although 10 percent of all respondents reported knowledge of actual sales, there was pronounced regional variation. Sunbelt States are experiencing the most foreign investment activity.[20/] The real estate professionals said that the average size of tracts purchased by foreign investors is three to five times larger than the average. The survey also showed that 19

15/ Sesker, Monte, "Wallaces Farmer Opinion: Foreign Investors Cause Concern Among Farmers." Wallaces Farmer, Des Moines, Iowa, May 26, 1979.

16/ "Opinion Poll Followup: Don't Sell Land to Foreigners." Progressive Farmer, Birmingham, Ala., April 1979.

17/ Harris, "Foreign Investment."

18/ Harris, Louis, "Foreign Investments Worry Americans," The Miami News, Miami, Fla., March 13, 1979.

19/ Larry Walker, supra note 2.

20/ These findings corroborate the statistical distributions in table 2.

percent of foreign-purchased farms are "operated" by the foreigners (presumably with hired personnel) and 69 percent by tenants or renters, with 12 percent in the "other" category.21/ Of the renters of foreign-held land, 23 percent are previous owners, 23 percent are previous tenants or renters, and 54 percent are new operators.22/ Of the sellers of land to foreign purchasers, 63 percent are previous operators, 23 percent are local landlords, and 14 percent are absentee landlords.23/ Uncertainty surrounds the issue of the economic effects of foreign ownership. However, dividing the set of respondents into those not aware of any foreign purchases or inquiries and those who indicate that people aware of actual foreign interests, the latter have much firmer opinions of the economic effects.24/

CONCLUSION

Whereas such a multifaceted issue as direct foreign real estate investment reveals no clear-cut course of action, certain facts do stand out and necessitate our recognition. They are:

1. The quantity of foreign investment is miniscule; less than .08 percent of one percent (1/1200) of the private land area of the United States has been transferred to foreign ownership in the 30 months covered in the data tables.

2. The investments have been concentrated in the far west and sunbelt States.

3. The rate of foreign purchasing has been dropping, significantly, since December 1978.

4. The investment preferences of foreigners are running at approximately a 10 to 1 ratio, in capital invested, in favor of urban real estate over rural real estate.

5. Most of the funds being invested come from Canada.

6. There is a wide range of investment preferences among the national "types"; i.e., investors from nations with a long industrial tradition, such as Great Britain and "English" Canada, tend to favor industrial and urban commercial properties.

7. A proportionally small segment of foreign real estate investment is being made by Arab investors, and this almost totally in urban tracts.

21/ Most of whom are assumed to be professional managers, based upon 281 useable responses.

22/ Based upon 218 useable responses.

23/ Based upon 298 useable responses.

24/ Walker notes, "as one would expect."

8. About 90 percent of the acreage has been purchased by individuals or corporations of Western European, Japanese, Canadian or other U.S. "allied," industrialized, democracies.

9. Foreign purchasers buy tracts of real estate three to five times larger than the average, but do not pay higher prices for their real estate than Americans (for tracts of the same size and quality).

Chapter 20

THE FOREIGN INVESTOR AS ABSENTEE OWNER

Paul Barkley*

INTRODUCTION

"Absentee ownership" is an emotionally charged term in the United States. The U.S. economy is predicated on the idea that many primary production activities are carried out by relatively independent individual entrepreneurs. While much--perhaps most--production is now done in industrial complexes that deviate sharply from this design, the resident owner operator still has an important role in U.S. culture. The role is so important that any deviation from it is suspect.

Absentee ownership is a loosely defined term used to describe a circumstance in which owners reside at some distance from a property. In a technical sense, the shareholders of large public corporations are absentee owners. The concern over absenteeism has not, however, centered on shareholders owning a modest number of shares in large corporations. The concern has centered most prominently on agricultural land, low-income urban housing, and, to an increasing extent, large, single-purpose capital structures (hotels, casinos, office buildings, and the like) that have been purchased by foreign investors.

Absenteeism is thought to be objectionable because it is accompanied by a separation of ownership and control. The conventional view holds that a person living miles away will not be an effective manager and will be in a position to exploit either the land, the capital fixtures, the resident manager, or all three. Problems can arise over the absentee owner exerting too much control or too little control--either of which can result in inefficiency, an inequitable distribution of returns, or a limited view of the relationship between time and resource durability.

The problems of absenteeism related to low-income housing have been elaborated in the popular and semipopular press. Most often, this elaboration has pitted slumlords against tenement dwellers regarding high rents and dilapidated housing. The problem of foreign investment in single buildings is a relatively recent phenomenon that has been somewhat sensationalized by the popular press. The absentee problem in agriculture is of much longer standing and has attracted popular, technical, and policy-making attention. This paper focuses on foreign absenteeism with respect to agricultural land.

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*/ Paul W. Barkley is Professor of Agricultural Economics at Cornell University.

Concern with absenteeism appears to be cyclical. In the case of agricultural land, the rapid expansion of railroads through the Midwest and Plains States brought large land companies that exploited land and tenants from headquarters in the metropolitan East. The 1930's brought economic depression and debt foreclosures that resulted in as much as 40 percent of the agricultural land in some States being owned by nonfarmers. Each of these eras invited public concern and saw conceptual and legislative activity dealing with tenancy and the ownership of agricultural land. More recently, especially since 1970, public concern has developed over foreign investors purchasing agricultural land in the United States. These purchases stem in part from the adverse balance-of-payments problems of recent years, and the domestic anxiety results partly from the changing structure and productivity of the domestic agricultural industry.

Although the extent of foreign investment in U.S. agricultural land is not known, the general concern over the possibility of large-scale investment requires inquiries into the possible effects foreign absentee ownership might have. This paper is designed to speculate on such possible effects and indicate what areas of information need to be expanded if reliable policies are to be developed relating to foreign absenteeism. The paper is arranged into sections dealing with the historical problem of absenteeism, the possible outcomes of a high incidence of foreign ownership, and a statement of some important issues related to policy. The paper is limited to economic effects and does not cover the sociological problems that might arise in connection with people of other races or other cultures purchasing large blocks of agricultural land.

ABSENTEE OWNERSHIP

The absentee owner of agricultural land is popularly thought to be a capitalist seeking maximum financial gains over time horizons that are much shorter than those used by occupant owners of similar capital assets. The shortened time horizon leads to exploitation of the capital, ruinous cropping patterns that deplete agricultural land, instability and fast turnover among tenants, and rapid depreciation of land-related capital improvements.

These traditional U.S. dispositions are part of the lore of tenancy and of landlord-tenant relationships that have their roots in feudal Europe, where serfs farmed land owned by lords and traded their labor for the use of the land. The degree of interdependence between lord and serf was very high, but the lords always had power to control the serf so this was viewed primarily as a one-way relationship: the powerful landowner made the rules and exploited the weak cultivators.[1/]

1/ An overview of the historical development of the land tenure system can be found in the 1968 edition of the International Encyclopedia of the Social Sciences (New York: Crowell Collier and Macmillan, Inc., 1968), especially under "Feudalism" (Volume 5) and "Land Tenure" (Volume 8). A more definitive treatment of the same subject can be found in Marshall Harris, Origin of the Land Tenure System in the United States (Ames: Iowa State College Press, 1953), especially chapters 2 and 3.

Feudalism did not necessarily involve absentee ownership as we know it today, but it instilled a persistent mood of distrust between owners and tenants. Part of that distrust has carried over to the present time and has been conveyed to the general public. The broad view also holds that only an owner-operator with a time horizon spanning several future generations can develop an appropriate disposition toward land use, maximizing economic returns, and conservation.

The question of tenancy and absenteeism is, however, much more involved that the condemnation of absentee landlords and tenants and the veneration of owner-operators. Even when confined to agricultural land, a parallel set of dispositions arises. One disposition centers on the tenant, a second on the landlord. The tenant-oriented view insists that the tenant who is left alone on rented land will not be interested in any goal other than the maximization of short-term gain. The tenant will, therefore, plant high-yielding crops without regard to maintaining soil fertility or preventing erosion. The tenant will allow capital fixtures to fall into disrepair because he, as tenant, has no way to recoup any gains or advantages that may be associated with their installation or upkeep. In this view, the tenant is thought of as an irresponsible citizen who needs close supervision from his landlord. Only the landlord can develop appropriate long-term interests in land.

A second disposition centers on the landowner. This view suggests that the absentee owner is an irresponsible entrepreneur concerned only with mining the soil and extracting the highest possible short-run gains. The tenants are at his mercy and are little more than pawns in a large exploitation scheme. An absentee landlord is not to be trusted with the management of long-term assets or natural resources.

These dispositions form the poles of a spectrum rather than exclusive categories and reality can be found anywhere along the line stretching from landlord-as-irresponsible to tenant-as-irresponsible.[2/] The dominant position along this spectrum is an empirical question that can be cast in terms of control. When agricultural land is owned by someone other than the individual who operates it, who is in control and who makes decisions relating to land use, conservation, long-run improvements, and stability? Absenteeism becomes important in this context.

Scholars, writers, and policymakers concerned with agricultural land have not developed a critical and unequivocal definition of an absentee owner. In a strict sense, the father who lives in town and owns the land farmed by his sons and daughters is an absentee owner. So is the engineer who inherited the family farm, but chooses to rent it to a neighbor rather than farm it. These individuals have not been interested in nor has it appeared that they threaten landownership, land use,

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2/ It is possible that, in some cases, both the landowner and the tenant are irresponsible and are attempting to extract the maximum short-term gain from their respective positions. In this setting, plans would be formulated using very short time horizons and very high rates of discount.

or the structure of the agricultural industry. Two groups, however, do seem to be of interest because they have an influence on farm operations and could affect the structure of the industry.

The first is the group that exercises no control over the tenant; the second is the group that exercises relatively complete control and insists that the tenant maximize the present value of a stream of income that arises over a relatively short period of time. In either case, the objectionable absentee landowner is one who allows decisionmaking to become short run and in so doing allows an irreplaceable natural resource to become depleted and shows little regard for the off-farm consequences of on-farm activity.

It often is hypothesized that the incidence of objectionable behavior among absentee landowners increases with distance between the farm property and the owner's home.[3/] If this is true, the foreign owner becomes objectionable almost by definition and the public may be correct in its fears about what foreign ownership will do to U.S. agriculture.

Very little is known about absentee ownership of U.S. farmland. The 1900 Census of Agriculture included an eight-page narrative commenting on absentee owners.[4] The analysis was adequate for its day, but now it appears very inadequate, when viewed from the perspective of 80 years. The 1900 analysis showed that nearly 80 percent of the absentee owners lived in the same county in which their farmland was located. Another 15 percent lived outside the county but in the same State, and the remaining 5 percent of the landlords resided in foreign countries. The average size of tenant-operated farm increased as distance between the farmland and its owner increased. Farms with owners in the same county averaged 85 acres; farms with owners in another part of the same State averaged 126 acres; and farms owned by foreigners averaged 159 acres. The census has not repeated the 1900 inquiry, but this relationship is thought to hold generally today: Farm size increases with distance between owner and operator.

3/ This particular problem of control can be conceptualized by using a framework similar to the locational matrix scheme hypothesized by T.W. Schultz in his 1953 book Economic Organization of Agriculture (New York: McGraw Hill Book Company, 1953). Schultz suggested that the market system works best in close proximity to locales where many market decisions are made and its effectiveness diminishes as distance from this commercial center increases. The same may be true of tenancy. The short- and long-run decisions regarding land use may be acceptable to both landlord and tenant and be consistent with society's goals so long as the landlord and tenant are in close proximity. Problems may increase with remoteness.

4/ U.S. Department of Commerce, Bureau of the Census. United States Census of Agriculture, Vol. I, No. 1, 1900, pp. lxxxv - xciii.

In 1945, Paul Wallace Gates published a lengthy article documenting some of the problems tenancy had caused on the American frontier.[5] The article recounts the activities of several landowners who had purchased land primarily for speculation and rented it to tenants until the conditions for sale became appropriate. Some of the landlords were foreigners.

Gates does not diminish the importance of the speculating landowner in providing land for pioneer farmers who were without capital resources. He also suggests that some landlords were quite liberal in their treatment of tenants, while others were very harsh. Perhaps the most advanced leasing practices were followed by William Scully, who also was one of the most excoriated absentee owners on the frontier. Contrary to common practices, Scully allowed tenants to remove and keep any permanent improvements they had made on the rented land. He usually entered into long-term leases (5 to 6 years) with his tenants, and he insisted that the tenant follow a crop rotation that prevented rapid depletion of the soil. Scully was, however, very unpopular because of the high cash rents he charged and his insistence that the tenant bear the property tax burden on the land. These features, coupled with poor crops and low commodity prices in the 1870's and 1880's, caused the eventual dissolution of the vast Scully holdings in Illinois, Nebraska, and Kansas.

The high cash rents demanded by Scully and some lesser known foreign owners caused outrage among tenants. The intensity of their resentment became manifest when antialien ownership bills were introduced in the legislatures of several Plains States.[6] Pressure against Scully and others was so great that in 1887 the U.S. Congress approved an Act restricting ownership in the territories to U.S. citizens.[7]

Reading the census commentary, the Gates article, and the handful of other documents relating to absentee owners is interesting, but not particularly satisfying. These and other publications are old, not well documented, and highly descriptive. No analysis suitable for aiding

5/ Paul Wallace Gates, "Frontier Landlords and Pioneer Tenants," Journal of the Illinois State Historical Society, June 1945. (This article also was reproduced and widely distributed through the Cornell University Press. The Cornell publication bore the same title and was distributed in 1945.)

6/ Gates suggests that the tax feature was the most objectionable feature of a Scully lease. Scully tenants and their neighbors resented the fact that he took rents from the local areas but did not pay local taxes. In fact, Scully was following an enlightened self-interest. Had he paid the taxes, tenants--who also were voters--would have felt free to vote in favor of several land-related improvements (schools, roads, courthouses, and the like) that would have raised Scully's taxes and subsequently lowered his net rents. By forcing tenants to bear the tax burden, Scully ensured that his tenants would not vote in favor of tax-increasing public activities. The idea of tax shifting apparently was unknown to the settlers of the Plains. [Gates (Cornell Printing), pp. 34-61.]

7/ U.S. Statutes at Large, XXIV:476.

extrapolation or inference is readily available and useable for policymaking purposes. The material that is available confirms the generally held feeling that absentee ownership can have harmful effects on tenants and on agriculture--and that foreign owners, because of distance, are more likely to impose detrimental practices on the land or on the tenant than domestic landlords living close by.

ECONOMIC EFFECTS OF ABSENTEE OWNERS

Tenancy has been an important part of the theoretical and descriptive work of land economists. Although much of the descriptive work was done during 1930-60, the theoretical work has its beginnings among Adam Smith and the classical economists. The theoretical work divides into two distinct parts, with the early theories coming from the careful articulation by Alfred Marshall and the more recent work stemming from relatively new work (post 1965) by Cheung, Sutinen, and others. Both bodies of work are designed to show which kinds of leasing arrangements will lead to the most efficient use of land resources over time.

Marshall's late-19th century treatment was straightforward. He suggested that tenancy has an important role in allowing combinations of resources to form and in providing joint decisionmaking roles--but that share-renting gives rise to inefficiencies and inequities, unless all costs are shared in the same proportion as returns. He noted that these share-engendered problems can be eliminated by using cash rents or other fixed-rent schemes that do not affect the decisionmaker's reliance on price ratios at the margin. The Marshallian view had wide application in agriculture, fishing, publishing, the setting of legal fees, and a number of other economic endeavors.[8/]

The more recent work also points out the importance of tenancy in resource assembly and decision-making. It differs from the early work by showing that share tenancy can, in the face of risk, lead to a more productive allocation of resources. It concludes that, under some circumstances, the landowner and the tenant both will be better off with share rents than with cash rents. Risk and perceptions of an uncertain future cause this to be true. The conclusion is inescapable. After decades of advising in favor of cash rents, policymakers and farm management advisors may now wish to turn attention to the share lease as a way of increasing agricultural output and ensuring agricultural stability.[9/]

8/ Alfred Marshall, Principles of Economics (eighth edition; London: Macmillan and Co., Ltd., 1920), especially pp. 637-59.

9/ The seminal arguments for this modern view were first given rigorous attention by Steven N.S. Cheung, The Theory of Share Tenancy (Chicago: University of Chicago Press, 1969). Others, especially J.G. Sutinen, "The Rational Choice of Share Leasing and Implications for Efficiency," American Journal of Agricultural Economics (57:613-621), November 1975, have continued to develop this literature.

Both views share the implication that landowner and tenant are in frequent contact with each other and that the landowner is reasonably familiar with the problems of output variability and price fluctuation in agriculture. An investor, foreign or domestic, with little knowledge of the industry may continue to select cash rents as a means of ensuring income, even though this can lead to misallocation in the agricultural industry.10/

Even though much theoretical work has been addressed to share leasing, cost sharing, and fixed rents, very few investigators have made empirical studies of the expectations and choices made by landlords. The reasons for this are at least partly pragmatic: It is very expensive to track down owners and, once found, nonfarmer owners of agricultural land probably are reluctant to talk about it.11/ They often have other occupations and are too busy in their other roles to give more than passing concern to the details surrounding the managment of a particular piece of land. This lapse in empirical work has caused both the analytic and the descriptive work related to absenteeism to require reconceptualization and updating. Such future work related to the economic effects of tenancy and absentee landlordism should consider several economic goals--and should be pursued from the perspective of the tenant, owner, local public (local community), and public at large. The inquiries should be related to efficiency, stability, growth, and equity. In any of the efforts, some distinctions should be made among classes of absentee owners. These classes should delineate several categories of domestic absentees as well as the foreign owners or investors in U.S. agricultural land.12/

10/ This assertion is partially borne out by the rapid increase in cash rentals in U.S. agriculture over the past decade.

11/ Many of the reasons land economists have failed to adequately research the problems of owners and tenants are explicated by Walter Chryst and W.B. Back, "Perspectives on Content and Methdology of Land Economics," in W.L. Gibson, Jr., R.J. Hildreth, and Gene Wunderlich, Methods for Land Economics Research (Lincoln: University of Nebraska Press, 1966), pp. 1-18.

12/ It is interesting to note that an asymmetrical disposition has developed in the treatment of landlords and tenants. Land economics research always has been concerned with the landlord, his proximity to the property, his motives, and his role in managing the farm. More recently, the residence and citizenship of the landowner have been perceived as a problem. No similar distinctions have been made among tenants. Tenants, however, can be divided into groups that could have quite different dispositions about the land. A tenant starting up the agricultural ladder may be in such desperate need of cash that he exploits the land and other farm capital. A part owner may treat rented land as if it were his own simply because it is easier to treat land the same.

Classes or Groups of Owners

Even though published literature relating to land tenure dates from before the 20th century, authors have not been consistent in their manner of describing the owners of farmland that is rented to others. The Census of Agriculture defines owner-operators (farmers who own all of the land they farm), part owners (farmers who own any part, but not all, of the land they farm), and tenants (farmers who rent all of the land they farm), but it does not classify or enumerate nonfarmers who own agricultural land and rent it to others. Any operational classification scheme should include elements of proximity and involvement in management decisions that impinge on farm activity. Four major groups or classes are suggested:

Relatives

Much farmland is kept within the same family for several generations. The settling of an estate between generations often yields a nonfarm absentee owner who resides some distance from the home farm but who rents land to siblings who are interested in remaining in farming. Rental arrangements vary from situation to situation, but--if there is a reasonable amount of good will in the family--the relative who is operating the farm usually has nearly complete freedom in making management decisions.

Local, Nonrelated Owners

Again, if good will exists, the owners will offer little by way of involvement so long as local customs are honored and the capital value of the property is maintained. If either of these conditions is violated, the lease or rental arrangement may be renegotiated to ensure either a flow of income, the maintenance of capital value, or both.

Non-local Domestic Owners

The dentist, teacher, engineer, or other professional who inherits the farm but does not wish to farm it and who has no relatives actively engaged in farming probably will avoid management of the property and may wish only to maintain the capital value of the asset. This generally calls for a lease that stipulates crop rotations and conservation practices, but does not allow for or require day-to-day involvement. Problems can arise if no stipulations are present. In these circumstances, the operator (tenant) has freedom to mine the farm or to utilize other capital-depleting practices.

Foreign Owners

Unfortunately, much of the current literature on land tenure and foreign ownership of U.S. farmland does not make sharp or uniform distinctions between aliens, foreigners, and U.S. citizens who live abroad. This is

not surprising since the several Federal agencies generally involved with foreign individuals or foreign trade have not developed uniform exclusive categories for foreigners.

This paper is concerned primarily with the economic effects of proximity and control, so the problem of sovereignty and allegiance is minimized. Only the broad categories of resident aliens, nonresident foreign owners, and U.S. citizens living abroad are considered in this context.

Resident aliens.--These are persons who reside in the United States but who are citizens of another country. This category includes recent immigrants and long-time residents who have not become naturalized citizens. There is no compelling economic reason to treat resident alien owners of agricultural land in a fashion different from nonrelated domestics. They should have the same economic motiviations as the domestic (related or nonrelated) landowners. An exception could occur if cultural differences caused the resident alien to impose special restrictions on a tenant--a seemingly remote possibility.

A second problem may arise in connection with the use of public (federally owned) lands. Aliens are prohibited from obtaining grazing or farming rights on these lands. The restriction could cause shifts in farming practices in parts of the intermountain West, where ranching generally requires a mix of private farmland and public range. The major issue with resident alien ownership stems from the emotional concern with sovereignty.

Does the United States want its farmland to be owned by anyone other than its own citizens? If the answer is negative, the question is resolved since no alien--resident or nonresident--could then own land. If the answer is affirmative, questions arise regarding the conditions under which a resident alien can own land and the special requirements the resident alien must meet in managing land. This is not a casual question, given the relatively large numbers of aliens who are now entering the United States from Mexico and Southeast Asia and the large number of land transactions recently consummated between U.S. citizens and Canadians.

Foreigners.--These are poeple who live in other countries and who are citizens of another nation. This is the group that includes newly rich Middle Easterners, European industrialists, and Canadians. One suspects that these are the people who made more-than-modest purchases of U.S. farmland in the early 1970's and are thus responsible for the long series of inquiries into whether foreign ownership of farmland can have a significant impact on U.S. agriculture. Scully was a foreign owner. He laid out specific requirements on how his tenants should behave, but--once assured that the tenants were following the rules--he left them alone. The major problems with a Scully or a similarly inclined contemporary foreign owner surround their dispositions toward type of farming and their reluctance or inability to become part of the local community.

U.S. citizens living abroad.--This group forms a relatively new class of owners or potential owners of U.S. farmland. These individuals probably have little interest in becoming involved with farm management, so their behavior likely is much akin to that of the foreigners. The only major difference would stem from culture and custom: the U.S. citizen living abroad likely would be cognizant of U.S. farming practices and thus more likely to impose restrictions that are close to customary on tenants who may farm the land.

The differences between resident alien absentee owners, foreign absentee owners, and absentee owners who are U.S. citizens living abroad must not be underemphasized in any conceptualization of economic problems related to absenteeism. These groups react to different sets of rules and, perhaps more important, they pay taxes under different taxing schemes. Their customs, incentives, and tax obligations may cause absentee owners in each of these three groups to make different suggestions on how their lands should be managed. These suggestions or lease requirements could relate to intensity of farming, crop selection and rotation, conservation measures, and long-term land improvements. This is a critical separation that must be made in future inquiries dealing with landownership and land use.

COMMENTS ON ABSENTEE OWNERSHIP

This paper cannot cover all situations that might arise with respect to all classes of landowners. In view of this, the remainder of this section is limited to discussions concerning absentee ownership by foreign owners. Different assumptions about management strategies are made to reveal some aspects of possible consequences of foreign absenteeism. In these cases, the worst possible outcome often is sought to make the point. The discussion is further limited by assuming that sovereignty and/or nationalism is not a problem. The individual absentee owner is treated in isolation.[13/] This rules out the possibility that a foreign nation could consciously decide to purchase enough U.S. farmland to be able to gain control of the industry.

Economic Efficiency

Nearly all of microeconomics is devoted in one way or another to finding the most efficient method of performing one or another economic activity. Efficiency divides into two parts--technical efficiency and economic efficiency. Technical efficiency relates to the physical combinations of inputs that can be used to produce a physical quantity of output. Technical efficiency is achieved when the minimum number of inputs are used to produce any given volume of product. Economic efficiency is slightly more complex. It involves a double criterion that takes price ratios as well as physical requirements into account. The first part of the criterion insists on technical efficiency; the second part insists

13/ This assumption is relaxed somewhat in the section dealing with rural communities.

on least cost. If products are produced using any but an economically efficient combination of inputs, society is devoting more resources than necessary to the production process.

This brief statement about production and efficiency has considerable significance in the world of absentee owners and rented or leased land. Land can be rented under share or fixed-rent arrangements. As was mentioned above, the share lease has been the most customary type for agricultural land, and it has captured the attention of most land economists. The share lease has several advantages. It eases the task of resource assembly and allows capital-short farmers to cultivate land without having to accumulate wealth or purchasing power first. It also provides some opportunities for specialization in decisionmaking functions, with the landlord making one set of decisions while the tenant concentrates on another.

Early investigators noted some problems with share leasing. The problems were related to the customary sharing arrangement in which shares were not specified for all inputs and all products. The crop shares in the United States were established decades ago and customary rental shares developed in most regions. The customary crop share in the Great Plains provides that one-third of the crop goes to the landlord and two-thirds to the tenant. In other areas, the crop is divided half-and-half. This arrangement is quite appropriate if both landlord and tenant agree to it, but prior to about 1970, most specialists in land and tenure problems thought that such an arrangement leads to inefficiencies in resource use.

Economic efficiency is based on price relationships, and the landlord taking one-third of a crop is the same as telling the tenant that the price he receives is only two-thirds of the market price. This reduction in the effective price alters all price relationships and leads the tenant to reduce the amount of product. Put another way, it leads him to reduce the intensity with which he farms the land. The tenant may make the economically correct decisions about intensity of land use, but in so doing he reduces the amount of product available to society.[14]

The typical suggestions made to eliminate this source of inefficiency were designed to make the tenant into an owner-operator or at least to

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14/ Interest in this theme was particularly high in the 1950's and 1960's. During those years, researchers and agricultural workers in several States addressed the problem in technical and popular form. See, for example, Virgil L. Hurlburt, "Farm Rental Practices and Problems in the Midwest," Iowa Agricultural Experiment Station, Research Bulletin 416, October 1954; Earl O. Heady and Earl W. Kehrberg, "Relationship of Crop-Share and Cash-Leasing Systems to Farming Efficiency," Iowa Agricultural Experiment Station, Research Bulletin 386, May 1952; and W.L. Gibson, Jr., and K.E. Loope, "Equitable Farm Leases" Virginia Polytechnic Institute, Extension Bulletin 254, January 1958. More recent work has been reported in Frank Reiss, "Landlord and Tenant Shares" Agr Econ Res Report 163, July 1979.

make him behave like one.[15] In the latter case, suggestions take one of two general forms that ask either that (1) all production costs be shared in the same ratio as the products, or that (2) the lease arrangement be switched from a crop share to a cash rental payment. The first results in the sharing system becoming neutral with respect to the relative prices of inputs and products. The second involves a lump-sum payment that has no effect on daily management decisions.

The more recent literature on share renting has not been so critical of sharing schemes. The criticism has softened because of increased knowledge about the relationship between risk and incentives. The contemporary view, while untested among domestic landlords or tenants, assumes that risk is a cost and the landowner will seek the optimum fashion in which to share that risk with a tenant. When the risk is optimally shared, the least-cost method (most efficient method) of production can be used. This argument generally is articulated from the landowner's point of view, but it has been extended to include the tenant's.[16] Sutinen also has expanded the theory to include transactions costs between owner and renter, as well as a number of variables that may affect the production process.

The question of how foreign absentee investors will behave remains largely unanswered by either the early and traditional view of share leasing or the later, more sophisticated treatment of the same subject. Both views imply that the owner of the land contributes very little by way of management decisions. The early view suggests the landlord maximizes returns over a time horizon that is different from the tenant's. The later view suggests that the landowner knows something about the variability in returns to agriculture, and wishes to escape some of the variation by sharing it with the tenant.

One can hypothesize that foreign investors will not follow recommendations to become involved in anything other than traditional share leasing. They often buy land for speculative or personal reasons and likely will not take time to develop the bookkeeping systems necessary to share all costs and all returns in the same fashion, nor will they develop enough knowledge of U.S. agriculture to enable the effective use of sharing as a tool of risk aversion.

The farm operators (tenants), on the other hand, likely would not favor cash rents. Farm operators in the United States traditionally have used share renting systems and have preferred this scheme because risks are shared and the rental payment fluctuates with crop yields. A cash rent,

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15/ The more recent suggestions of this type are elaborated by D.W. Adams and N. Rask, "Economics of Cost-Share Leases in Less Developed Countries," American Journal of Agricultural Economics (50:935-42), November 1968; and Vernon W. Ruttan, "Equity and Productivity Objectives in Agrarian Reform Legislation: Perspectives on the New Philippine Land Reform Code," Indian Journal of Agricultural Economics (19:114-30), 1964.

16/ See Cheung and Sutinen, loc. cit.

aside from violating tradition, can be hard to meet when yields or agricultural prices are low.

Since any modification of the simple, traditional crop share lease may meet with considerable objection, it seems likely that the foreign absentee owner will continue to be a potential source of inefficiency in U.S. agriculture. The magnitude of the inefficiency is dependent upon the amount of land held by foreign absentees, but it is an empirical question.

Intensity of Land Use and Composition of Output

Farming is a diverse occupation. Some types of farming require huge investments, constant adjustment of decisions, and a high degree of sophistication in monitoring day-to-day activities. Other types of farming require infrequent decisions, little adjustment, and almost no monitoring. A dairy operation is in the first category, a farm producing only meadow hay is in the second. Generally speaking, the first is an intensive operation and the second is extensive. The first requires a large volume of inputs per unit of output; the second requires very few.

Although it is dangerous to generalize, intensive farms usually require more managerial skill than extensive farms. It is reasonable to suggest that foreign absentees would be reluctant to become directly or indirectly involved with high-intensity farming. They would be more inclined to choose a relatively stable pattern of low-intensity farming. A foreign owner who purchases acreage in Iowa may decide that the existing, risk-spreading, diversified pattern of farming is too complex and insist that the entire farm be used for continuous cash grain cropping. The effects of such a switch could alter the composition of output in a local area sufficiently to have a noticeable effect on other operators and on farm-related businesses. As in the case of efficiency considerations, the issue relating to intensity of land use can be stated as a researchable empirical issue.[17/]

Conservation of Land and Related Resources

Writers of both technical and popular pieces always lament a system of land tenure that includes a high proportion of renters.[18/] They argue

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17/ For an extensive commentary on this issue, see Mason Gaffney, "Social and Economic Impacts of Foreign Investment in U.S. Land," Foreign Investment in U.S. Real Estate. U.S. Department of Agriculture, Economic Research Service, 1976, pp. 143-67.

18/ An example of the former type is O.T. Osgood, "Some Observations on the Relation of Farm Land Tenure to Soil Erosion and Depletion," Journal of Land and Public Utility Economics (17:410-22), November 1941. An example of the latter is John Steinbeck, The Grapes of Wrath (New York: Bantam Books, 1939).

that such a system will be more exploitative than a system made up primarily of owner-operators. The evidence to support this contention is not always convincing. The Gates article described some large land speculators who provided tenants with leases that clearly depleted the soil, and others who developed leasing practices that encouraged the maintenance of soil fertility. Salter, in his 1946 review of land economics research, concluded that there was some mild evidence that tenants were more exploitative, but the scholars researching the question may have used research methods that were faulty or naive. The conclusion they reached is suspect.[19/]

Rational decisionmaking rules insist that the tenant deplete the land. The tenant operates with indefinite tenure and, in so doing, should maximize the present value of a stream of income that will accrue over a relatively short period of time. The owner-operator has a longer planning horizon and can afford to sacrifice some present (short-term) income to maintain either the capital value of the farm or the long-term future income stream that will be realized from it. The long-term argument favoring the owner is enhanced if the owner has heirs to whom he wishes to convey the farm.

Gates and others have argued that it is the landlord's responsibility to maintain soil productivity. Apparently, this is to be accomplished by lease conditions that specify length of tenure, cropping patterns, and essential conservation practices. The foreign absentee investor is in a poor position to dictate, or even suggest, conservation practices that would ensure the protection of the soil. The soil is at the mercy of the tenant. Fortunately, the evidence is not harsh on tenants. They, in general, have a long tradition of violating their own self-interest to follow common soil-saving practices.[20/]

Rural Communities

Vital rural communities once were the hallmark of a healthy U.S. agrarian economy. A variety of forces related to farm mechanization, improved transportation, and improved communication have increased farm size and diminished the number of potential patrons in any given trade area. Consequently, the need for small towns has diminished, and many small communities continue to decline in importance.

19/ Leonard A. Salter, A Critical Review of Research in Land Economics (Minneapolis: University of Minnesota Press, 1948), especially pages 235-41.

20/ A recent study by Dillman, *et al.*, indicates that absentee owners in the Palouse region of the Pacific Northwest are convinced that "everything reasonable" is being done to conserve soil, but they seldom, if ever, talk with their tenants about the problem and they seldom, if ever, make lease stipulations relating to conservation. Don A. Dillman, *et al.*, "The Influence of Absentee Landowners on Use of Erosion Control Practices by Palouse Farmers," Washington State University, College of Agriculture Research Center, Circular 607, May 1978.

The relationship between tenure and communities has not escaped notice. It is supposed generally that a high incidence of farm tenancy will erode the cohesive bonds that hold a community together: The tenant has only short-term interest in the land and area, so he cannot be expected to generate long-term interests in the town, its civic clubs, and its schools. The activities of Scully tenants, as reported by Gates, however, may imply the opposite--that tenants are as interested as anyone else in community and public activities. Scully's tenants were required to pay the tax on the land they rented. As a result, they were not able to saddle a foreign absentee with a large tax bill, the revenues of which were to be used to further the local public purpose. It can be implied that the Scully tenants were angered because they could not participate in community affairs; their taxes were too high. This is, however, a tenuous argument.

Foreign absentees may have an effect on communities, but that effect is likely to be overshadowed by the effect of agricultural prices or the effect of changing technology. The exception arises in the case of large blocks of land in a geographically confined area being foreign owned. If the foreign investor switches land use patterns from labor-intensive to capital-intensive farming, the local town may suffer because of the reduction in agricultural workers who also are customers of local businesses. Similarly, if the foreign owner brings in alien workers to operate the farm, the local community may not provide a suitable place for the workers to satisfy their need for socializing.

In sum, a variety of economic effects could stem from foreign investment and the subsequent absentee ownership of U.S. farmland. These effects could be related to economic efficiency, the composition of aggregate agricultural output, soil conservation, or rural communities. It seems unlikely, given the known incidence of foreign ownership, that any of these problems will become severe in the near future, even if contemporary sales trends continue. Moreover, it seems unlikely that the effects--good or bad--of foreign absentee owners would differ markedly from the effects that domestic absentee owners or owners who are U.S. citizens living abroad may have. The question remains one of decision-making, proximity, and control. To this point, there is no alarming evidence that foreign investors in U.S. farmland have had a serious, deleterious effect on U.S. agriculture.

DISCUSSION

Much of the foregoing has been based on theoretical and a priori notions of what ought to be or what ought to happen in a world peopled by self-serving, independent decisionmakers. Most of the theoretical situations posed in the paper can be reduced to empirical questions. Researchers working on problems in foreign trade and in land tenure have been unable to document the real effects of absenteeism. The question arises as to whether such investigations should be initiated and what form they should take.

Land is clearly an important natural asset that requires careful attention in law and policy. Its supply is, for all practical purposes,

limited, and the demand for land is becoming more intense. Major changes in land use usually are accompanied by close public scrutiny and, increasingly, by policies or rules that in some way limit the nature of the change. Land is especially important in the United States because of its role in the system of values and beliefs and the strong agrarian tradition espoused by many U.S. citizens.

The role of land may be more important in 1979 than it was in (say) 1950 because the public supposes there could be a shortage of agricultural land in the country. This supposition stems from the rapid increase in food prices and the highly publicized shift of land from agricultural to nonagricultural uses. In fact, there is little reason to believe that shifts in land use are responsible for high food prices or that U.S. agriculture is incapable or only marginally capable of providing adequate food to meet domestic needs. The important real issue is the increased role of agricultural land in providing foodstuffs that can be exported to help pay the extremely high costs of oil imports. The question remains as to whether foreign investors are in a position to jeopardize food production for this or any other purpose. Moreover, does their position as absentee owner per se have any impact on the problem?

An inquiry to find the effects of absentee ownership on U.S. agriculture could, but need not, differentiate between foreign and domestic absentee owners. The problem would be the same. Land tenure researchers never have been successful in tracing the owners of farmland. The owners may be identified as living in the county or in the State, but making contact with them and eliciting information about management and control is extremely time-consuming and expensive. Its expense would increase if this kind of study were extended to include foreign owners.

The conceptual link between the perceived problem and the empirical investigation is quite clear. If foreign investors are finding U.S. farmland to be an attractive investment, policymakers should ask researchers to help them answer the following questions:

1. Why is U.S. farmland an attractive investment, and how does it compare with nonfarm real property and other forms of long-term capital?

2. How much U.S. farmland will foreigners purchase in the future?

3. What role will foreign owners have in the management of any farm real estate they may acquire?

4. Under what circumstances could foreign investors influence the structure and performance of the domestic agricultural industry?

5. If structure and performance are affected, does any of the effect come specifically from tenure arrangements or from the foreign investor's role as absentee owner?

Given present knowledge about the extent of foreign ownership of U.S. farmland and the minimal controls that foreigners appear to exert on

domestic operators (tenants), it seems untoward to recommend a massive study. Until and unless foreign ownership becomes a real problem, it seems more reasonable to suggest a monitoring activity whereby foreign purchases are recorded and watched. If they become concentrated, investigations about effects could begin.